SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1966

No. 127

FEDERAL POWER COMMISSION, PETITIONER,

vs.

UNITED GAS PIPE LINE CO., ET AL.

No. 128

MEMPHIS LIGHT, GAS AND WATER DIVISION, PETITIONER,

vs.

UNITED GAS PIPE LINE CO., ET AL.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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In The

United States Court of Appeals

For the Fifth Circuit

United Gas Pipe Line Company, *Petitioner,* v. Federal Power Commission, *Respondent,* City of Memphis and Memphis Light, Gas and Water Division, et al, *Intervenors.*	No. 21872
United Gas Pipe Line Company, *Petitioner,* v. Federal Power Commission, *Respondent,* City of Memphis and Memphis Light, Gas and Water Division, et al, *Intervenors.*	No. 21958

JOINT APPENDIX

Volume I

Transcript of Testimony

(Joint Appendix Pages 1 to 125;

Record Pages 205 to 3676)

Excerpts from testimony of H. B. Dorau, a witness for UGPL Co.

Direct Examination

Q. Has United had any significant change in the cost of its debt capital in the period since June 15, 1961?

A. There has been a small increase in the cost of United's debt capital. This resulted from the issuance of two 4½ percent notes, one for $10,000,000 and the other for $36,000,000. Both notes are for a period of three years, the first having been issued on January 22, 1962, and the second note having been issued March 13, 1962. Both notes are owned by United Gas Corporation, parent of United.

The cost of United's outstanding debt capital prior to the issuance and sale of these notes was 4.42 percent and thus was increased slightly to 4.44 percent. The details of the outstanding debt capital of United are furnished in Statement F(3) page 1 of 2.

Q. Has there been any significant change in the cost of debt capital to United Gas Corporation in the period since June 15, 1961?

A. The increase in cost of debt capital to United Gas Corporation has been

(End of Page 4)

greater than the increase in cost to United. For the period involved (June 14, 1961 to March 31, 1962) cost of debt capital to United Gas Corporation increased from 3.94 percent to 4.05 percent (Statement F, Exhibit 8 in Docket RP60-2, and Statement F of the current filing) and has increased slightly with the issuance and sale of $40,000,000

of bonds sold on June 6, 1962, at a cost of 4.5058 percent, exclusive of expenses estimated at $175,000. The two factors responsible for this increase in cost of debt capital to United Gas Corporation are: (1) the reduction through the operation of the sinking funds for the older outstanding low cost issues of bonds and debentures, and (2) the additional borrowing of $80,000,000 in the form of two bank loans of $40,000,000 each at an interest rate of 4½ percent. At June 30, 1961, United Gas Corporation's outstanding debt consisted of $387,703,000 of bonds and debentures having a weighted average cost of 3.94 percent. As of March 31, 1962, this had been reduced to $370,307,000 but during this period $80,000,000 was borrowed from banks. The net result is that as of March 31, 1962, United Gas Corporation's outstanding debt amounted to $450,307,000 with a weighted average cost of 4.05 percent.

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Q. What has been the change in bond yields and interest rate from June 1961 to April and May 1962 for which information may be available?

A. Interest rates and bond yields have not changed much from June 1961 to recent dates. The following may be noted:

(1) The yield basis on which 3-month Treasury Bills sold increased from 2.359 percent in June 1961 to 2.735 percent in April 1962;

(2) Long-term government bond yields rose from 3.88 percent in June 1961

(End of Page 5)

to 3.89 percent in April 1962;

(3) Prime commercial paper rates rose from 2.91 percent in June 1961 to 3.20 percent in April 1962;

(4) The yield on Moody's industrial bonds declined from 4.54 percent in June 1961 to 4.42 percent in May 1962;

(5) Moody's public utility bonds series declined in yield from 4.52 percent in June 1961 to 4.50 percent in May 1962;

(6) The yield on Moody's rail series was unchanged at 4.83 percent.

Q. What significance do you attach to these changes?

A. The changes are mixed and so small as to have little or no significance for the purpose at hand.

Q. Would these changes in bond yields indicate the

possibility of some reduction, however small, in fair rate of return for United today as compared with the fair rate of return at or about June 30, 1961?

A. No, because the change was too small and for other reasons.

Q. Please explain.

A. There are two other reasons. (1) The Federal Power Commission's practice of determining the fair rate of return allowance applicable to debt capital has been to base such allowance upon imbedded or historical cost of debt capital for the particular company and not upon the current cost of such capital for the class of enterprise or even the particular company when available. (2) The actual cost of debt capital to both United and to its parent, United Gas Corporation, will continue to increase for the indefinite future because of the influence of the operation of sinking funds. These sinking fund requirements call for a relatively faster repayment of the older

(End of Page 6)

low cost capital so that the bonds and debenture which remain outstanding tend to increase in cost. Another influence at work is the fact that current borrowing costs exceed the weighted average of historical or imbedded costs. Therefore, unless the bond markets rise quite substantially and bond yields drop correspondingly and large financing is undertaken at

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lower than historical cost, there is no possibility that the weighted average cost of debt capital for United or its parent, United Gas Corporation, will decline in the foreseeable future.

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Q. Why did you select A and Baa grade bonds for this part of your analysis?

A. Because these are the quality ratings given to the bonds of the United Gas Corporation, A for the mortgage bonds

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and Baa for the debentures.

(End of Page 17)

Q. What is the significance and meaning of Table 5?

A. The tabulation on Table 5 records the capital cost experienced by the natural gas transmission companies from 1951 through March 31, 1962, on first lien obligations rated A. The yield range is wide, from 2.83 percent yield to investors in 1951 to 4.62 percent on January 11, 1962.

(222)

The table also calls attention to the fact that yields to investors are not the same as cost to the company. Column 7 records the cost rate to maturity at net proceeds. The cost of financing yield differential for recent issues has been from .10 to .12 of one percent.

The tabulation also sets forth the pro-forma debt ratio and the amount by which the yield to investors on each issue was above or below the average yield on Moody's A rated bond yield index. The last two issues sold on a yield slightly below Moody's average but generally the yield at offering price was higher than the average for A rated utility bonds.

Q. Where is the financing experience of United set forth?

A. In Statement F(3), on page 1 of 2.

Q. And where for the parent company, United Gas Corporation?

A. On page 2 of Statement F(3).

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Q. What do you find was the market experience of United Gas Corporation's most recent sales of bonds?

A. The most recent financing of United Gas Corporation was on June 6, 1962, when $40,000,000 first mortgage and collateral trust bonds due 1982 were sold to investors on a 4.45 percent yield basis.

On a previous trip to the market on November 1, 1960, involving a

(End of Page 18)

two-pronged financing, first mortgage bonds and sinking fund debentures, the following yield and cost bases were established:

(1) A-rated 5 percent first mortgage bonds due 1980, 4.88 percent yield to maturity at offering price and 4.98 percent cost at net proceeds to the issuing corporation;

(2) Baa rated 5⅛ percent sinking fund debentures due 1980, 5.05 percent yield to maturity at offering price and 5.15 percent cost at net proceeds to the issuing corporation.

In both cases the cost-yield differential which represents the cost of financing was .10.

If the 1960 experience is applied to the present June 1960 financing, the following cost to United Gas Corporation can be derived as follows:

(1) For first mortgage bonds 4.45 percent yield basis which after cost of financing of .10 becomes 4.55 percent cost to the issuer,

(2) For sinking fund debentures by trending 1960 experience to present first mortgage financing 4.60 percent yield basis $(\frac{5.05}{4.88} \times 4.45)$ which after cost of financing of .10 becomes 4.70 percent cost to the issuer.

Giving effect to the present June 1962 financing on a pro-forma basis with respect to the proportion of first mortgage bonds and sinking fund debentures as total debt component, the result would be 68.5 percent of senior and 31.5 percent of junior debt.

Applying these weights to the cost basis established in (1) and (2), respectively, a weighted cost of 4.60 percent is derived [(4.55 x 68.5) ÷ (4.70 x 31.5)].

(End of Page 19)

Q. How does the historical weighted average cost of debt capital for United Gas Corporation compare with that of United?

A. The average dollar past cost for United was 4.44 percent and for United Gas Corporation was 4.05 percent.

Q. How does the price paid by United to United Gas Corporation compare with the price United Gas Corporation has most recently paid for debt money?

A. United is paying 4.50 percent on notes and United Gas Corporation is paying 4.50 percent on bank loans.

Q. What are the market yields on selected outstanding first mortgage bonds of United Gas Corporation?

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A. As of March 1962, 4.34 percent on the 3⅝ percent issue, 4.32 percent on the 4½ percent issue and 4.60 percent on the 5 percent series of 1980. They average 4.42 percent.

Q. What was the market yield on the more recently issued sinking fund debentures of United Gas Corporation?

A. On the 4⅜ percent issue of 1972, 4.54 percent; on the 4⅝ percent issue of 1978, 4.48 percent; and on the

5⅛ percent issue of 1980, 4.80 percent. The three average 4.61 percent yield in March 1962.

The average yield on the six outstanding selected bonds of United Gas Corporation at the average March 1962 prices is 4.51 percent.

Q. What do you conclude as to the available cost evidence?

A. There is a difference between the historical cost of 4.05 percent to United Gas Corporation of debt capital employed and the current weighted cost of debt capital of 4.60 percent as derived from the recent market experience in June 1962, or the current cost of 4.51 percent (before an allowance for the

(End of Page 20)

difference between yields on outstanding bonds at market prices and yields at offering prices for new issues and before cost of financing) as derived from average yields on outstanding selected first mortgage bonds and sinking fund debentures at

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average March 1962 market prices.

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Q. What information is set forth on Table 21?

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A. Table 21 sets forth the sinking fund schedule for the First Mortgage and Collateral Trust Bonds and the Deben-

tures of United Gas Corporation. This schedule of the accruing liability to repay is of practical importance since United Gas Corporation is the vehicle for public financing for United. The future final maturities and sinking fund requirements are substantial as may be seen from the extreme righthand column and the column headed "Semi-annual," total by years for the First Mortgage and Collateral Trust Bonds. The total fund requirements by years on the basis of securities then outstanding are:

(End of Page 26)

1961	$15,673,000
1962	16,915,000
1963	18,221,000
1964	18,897,000
1965	19,599,000
1966	20,326,000
1967	48,952,000
1968	16,182,000
1969	16,846,000
1970	22,965,000
1971	29,987,000
1972	43,374,000
1973	16,538,000
1974	8,398,000
1975	14,384,000
1976	8,127,000
1977	17,306,000
1978	25,551,000
1979	3,137,000
1980	22,496,000

Q. Have you also calculated the actual average dollar maturity for United Gas Corporation's First Mortgage Bonds

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and Sinking Fund Debentures?

A. Yes. The three 20-year First Mortgage Bonds listed below have the following average maturities:

3⅜% due 1971 — 14 years, 5 months,
4½% due 1977 — 15 years, 7 months,
5% due 1980 — 14 years, 10 months.

This is just about half the term of loan of a typical 30-year electric utility bond.

The three 20-year sinking fund debentures have an average dollar maturity as follows:

4⅜% due 1972 — 14 years, 5 months,
4⅝% due 1978 — 14 years, 5 months,
5⅛% due 1980 — 14 years, 10 months.

Q. What bearing do these facts have on the comparative cost of debt capital?

(End of Page 27)

A. Direct comparisons of the yields on utility and gas transmission company bonds should not be made to reflect cost of capital evidence. To make direct comparison proper it needs to be determined what a natural gas transmission company would have to pay on a thirty-year bond with no sinking fund or other acceleration of maturity. The answer probably is they couldn't get such capital at a price worth paying because of the reliance on a wasting asset industry.

The actually shorter maturities and the sinking fund

operation leads the market to tolerate higher debt ratios, at least initially until "worked down" for gas transmission companies than for electric utilities. If this higher spot debt ratio is used to weight the cost of debt capital, it will operate to prejudice the composite dollar cost of capital and thus the fair rate of return so far as it may be derived therefrom.

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Q. After having analyzed the evidences as to the cost of debt and the cost of equity capital, what yet needs to be done before determining an average dollar cost of capital?

A. It still needs to be determined what weights to give each class of capital cost in order to find a composite or average dollar cost.

Q. What facts have you gathered as a basis for this determination?

A. There have been set forth in Statement F and in the supplement to Statement F the debt and equity ratios for United Gas Corporation and United, as well as the capital proportions

for the 10 comparison transmission companies

(ends page 48)

(Table 18). They may be summarized for convenience as follows for 1961:

	Debt	Preferred	Common
10 Transmission companies..	59.0	9.9	31.1
United	55.5	—	44.5
United Gas Corporation	59.2	—	40.8

As of March 31, 1962, the ratios for United and United Gas Corporation were:

	Debt	Common
United	60.14	39.86
United Gas Corporation (Cons.) ..	60.69	39.31

Q. In summary, what evidences of the cost of debt capital will you use for alternative composite cost of capital calculations?

A. I will make alternative composite cost of capital determinations for:

United:

Imbedded average dollar cost	4.44%
Current cost of debt capital at a 60% ratio	4.85%

United Gas Corporation (Cons.):

Imbedded average dollar cost	4.05%
Current cost at a 60% debt ratio	4.60%

Q. What evidences of equity return ratios do you bring forward for alternative use in the determination of a composite cost of capital determination?

A. I would draw upon the exhibit, text and text tables for the following:

1. Ten natural gas pipe line companies:

a. 1971 earnings on common equity:

(1) average of ratios as reported on average equity	13.65%
(2) weighted average ratio, adjusted for refunds on beginning of year equity	13.59%
(3) average of ratios adjusted for refunds on average equity	13.65%

(ends page 49)

b. Average 1946-1961 earnings on common equity:

(1) average of ratios as reported on average equity	16.05%
(2) weighted average ratio, adjusted for refunds on beginning of year equity	16.62%
(3) average of ratios, adjusted for refunds on average equity	15.62%

c. Earnings-price ratios on common stock:

(1) average of current earnings to current prices 1946-1961	7.37%
(2) 7.37%, adjusted by average investor experience, 1946-1961	11.43%
(3) 7.37%, adjusted by weighted average investor experience, 1946-1961	13.46%
(4) 7.37%, adjusted by average discounted earnings-price ratios, 1946-1961	10.36%

(5) 7.37%, adjusted by weighted average investor experience, 1946-1961 ..... 10.94%

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d. Equity investor experience on compound return basis:

(1) average of investor return experience, 1946-1961 ..... 12.5%

(2) weighted average investor return experience, 1946-1961 ..... 12.1%

(3) average of investor return experience, 1949-1954 ..... 11.8%

2. United Gas Pipe Line Company:

a. Average 1946-1961 earnings on common equity:

(1) average of ratios, income as reported on average equity 8.27%

(2) average of weighted ratios, income adjusted on beginning of year equity.... 7.27%

(3) average of ratios, income adjusted on average equity 7.60%

(ends page 50)

3. United Gas Corporation:

a. Equity investor experience on compound return basis:

(1) average of investor return experience, 1946-1961 ..... 9.5%

(2) weighted average investor return experience, 1946-1961 ..... 8.6%

4. Equity investor experience in other industries:

(1) 10 natural gas distributing companies, 1952-1961 ..... 16.3%

(2) 30 natural gas companies 1952-1961.... 12.5%

(3) Moody's 24 electric utilities 1952-61..... 14.2%

(4) 25 railroads, 1952-1961 ..... 8.3%

(5) 125 industrials, 1952-1961 ..... 14.4%

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Q. Will you now indicate how the composite cost of capital is derived from the evidences developed?

A. A first determination may be made on the basis of the imbedded debt capital cost of 4.44% for United with a debt ratio of 60% as of March 31, 1962.

Using for this purpose the average of the four adjustments made to the average earnings-price ratios for the 10 comparison companies for the period 1946-1961 of 7.37% to reflect investor's actual experience as shown in l.c., (2), (3), (4) and (5) of 11.5% for an equity cost, will produce the following:

4.44% debt cost at 60%	equal	2.664%
11.5 % equity cost at 40%	equal	4.600
Average dollar cost		7.264%

Using a current debt capital cost of 4.6%, as derived from market valuations for the debt of United Gas Corporation, the result would be:

(ends page 51)

4.6% debt cost at 60%	equals	2.76%
11.5% equity cost at 40%	equals	4.60
Average dollar cost		7.36%

Using an estimated debt capital cost to United of 4.85%, the result on otherwise the same basis would be:

4.85% debt cost at 60%	equals	2.91%
11.5% equity cost at 40%	equals	4.60
Average dollar cost		7.51%

Using as a base the experienced equity earning rates for

the 10 comparison companies of 13.59% for 1961 and the capital structure ratios as of the end of 1961 of 31.1% equity for the 10 comparison companies and 44.5% for United, affords another test. To use the ratios for the 10 comparison companies, however, requires adjustment for the difference in equity ratios. Adapting the 13.59% equity rate to the 44.5% United Equity ratio in direct proportion to the difference in equity proportions, results in a 12.0% ratio applicable to United. Applied as above in

combination with an imbedded debt cost of 4.44% produces the following:

4.44% debt cost at 55.5%	equals	2.46%
12.00% equity cost at 44.5%	equals	5.34
Average dollars cost		7.80%

Substituting a current debt capital cost of 4.6% for the 4.44% past cost, produces the following result:

4.60% debt cost at 55.5%	equals	2.55%
12.00% equity cost at 44.5%	equals	5.34
Average dollar cost		7.89%

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Q. What further evidence as to the relative investor appraisal of divisions of the gas industry have you provided on Schedule 2C?

A. On Schedule 2C, there is offered the evidence as to the rating given six gas companies identified in Staff Exhibit as "holding companies".

In fact, as is set forth in the schedule immediately following #3, five of these companies, i.e., excluding United Gas Corporation, are large gas distributing systems. Moody's classified five of this group as integrated companies. The dominance of the gas distributing function makes the inclusion of United Gas Corporation a strain on the homogeneity which should be the basis of classification and grouping. Five of the companies on Schedule 2C are in structure holding companies. The one which is an operating company as

well as owning the stocks of other corporations is United Gas Corporation. The corporate structural form is not of prime importance however. It is the dominant character of the operations and class of service rendered.

A tally of the rated bonds of the five systems dominated by local distribution service discloses that out of 79 issues, 25 are Aa, 41 are A, 12 are Baa, and 1 is Ba, clearly a very different quality level

(End Page 5)

than that found for pipe line companies, and incidentally 3 of the Baa rated bonds are those of a pipe line subsidiary.

Q. Will you now refer to Schedule 3 and explain what it sets forth?

A. Attention is first directed to the figures in Column 1 showing the proportion of gas revenue obtained from residential and commercial service. The integrated distribution companies obtain an average of 57% of their revenues from residential and commercial service while for United Gas Corporation this business accounts for only 12.8%. Sales for resale accounted for an average of only 15.1% of the revenue of these ten companies, while representing 35% of the revenue of United Gas Corporation, consolidated.

In Staff exhibit ...., United Gas Corporation is included with the first five of the ten companies set forth in Schedule #3 under the label "holding comapnies". Using then only the

first five companies in Schedule 3 it may be noted that the distribution of gas revenue only, since the group of 5 has substantially no non-gas revenue, is as follows:

	Percent — Distribution of Gas Revenue			
	All Gas Revenue	Residential Commercial	Industrial Sales Revenue	For Resale Revenue
Five companies	100.0	63.7	20.7	15.6
United Gas Corp. (Cons.)	100.0	15.1	43.7	41.2

In contrast the 10 natural gas pipe line companies (based on 9, 1 unavailable) identified on Schedule 3 and used in Staff Exhibit .... reflected an entirely different distribution of gas revenues by reference to either the five distribution systems previously noted or United Gas Corporation (Cons.).

(End Page 6)

	All Gas Revenue	Residential Commercial	Industrial Revenue	For Resale Revenue
Pipe Line Cos.	100.0	4.1	12.1	83.8
United Gas Corp. (Cons.)	100.0	15.1	43.7	41.2

Q. What conclusion do you draw in general from the analysis of Schedule 3?

A. Five out of the six companies identified as holding companies in Staff Exhibit ...., page 43, are in fact predominantly distribution systems and not similar in character of business to United Gas Corporation (Cons.). These five distribution systems are again very different in character of

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business from the natural gas pipe lines identified in the lower part of Schedule 3. It is United Gas Pipe Line Company that could be properly identified with the pipe line companies and in this comparison important differences are to be noted as set forth in company (Dorau) testimony, pages 35-38. Distributing gas utilities are clearly to be distinguished from natural gas pipe line companies and natural gas producers. United Gas Corporation operates in only a relatively small way as a gas distributing utility. Its natural gas production is through a separately organized and operated subsidiary as is its natural gas transportation business.

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Q. What further evidence as to the level of earnings achieved and available in industries of equal or less risk than that characterizing the natural gas pipe line enterprises is provided in Schedule 4B?

A. Schedule 4B reflects the results experienced by the common stock investment in 10 natural gas transmission companies from 1952-1961.

The market price increased from $33.88 in 1952 to $64.28 in 1961, an increase of $30.40, or 89.73%. Dividends per share increased from

(End Page 9)

$1.45 to $2.83, an increase of $1.38, or 95.2% in 10 years.

In the lower half of tabulation on Schedule 4B there is set forth the return rate earned on common equity for the

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Moody selected 10 gas distribution companies for the years 1956-1961. The range is from 11.7% to 12.4% on an aggregate (weighted by size) basis and from 12.3% to 13.1% on an average of rates of return earned. As a division of the gas industry this level of earnings affords a basement level from which the necessary return rate for the more hazardous pipe line division of the industry may be developed. A level above 12% for the extra hazard of pipe line investments is indicated and this leaves no margin as such for absorbing the extra-extra levels of risk and uncertainty reflected by any associated natural gas production.

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It may further be noted by reference to the table in the lower half of Schedule 4B that the market price of the gas distributing company common equity has increased from $28.41 in 1956 to $59.36 in 1961, an increase of $30.95 or a 108.9% increase in 5 years. The dividend rate increased from $1.43 to $1.91, or 33.6%.

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Q. What general conclusion do you draw from these evidences of investor experience with earnings, dividend and market price increase?

A. That earnings-price ratios afford no measure of investor return expectation or achieved return rates during a bull market and probably never except by chance.

(End Page 11)

Q. What is the purpose of Schedule 5?

A. Schedule 5 sets forth, comparatively, the results

in terms of percent return available on the common equity at a predetermined 6.5% rate of return of the use of various debt capital cost rates and two alternative debt ratios.

Thus, at a 60.39-39.31 capital structure an inbedded debt cost rate of 4.5% will leave as a balance 10.28% on equity. This is as reflected in Staff Supplemental Exhibit ....., at page 1. I understand that this imbedded cost of debt capital is for United Gas Corporation but presumably to apply to United Gas Pipe Line Company.

In order to test the effect of the arbitrary selection of debt cost rates I substituted the several obvious alternatives even though I am quite aware of the baekwards character of the procedure and that apparently there is no direct determination of a return ratio for common stock capital.

If in the first instance the imbedded 4.44% cost of United Gas Pipe Line Company were used to find a return rate for United Gas Pipe Line, the balance for common stock would be 9.60% and not 10.28%.

If the current cost of debt capital found by reference to the market appraisal of United Gas Corporation securities of 4.60% were used the rate for the common stock equity by the residue method would fall to 9.35%.

If the current cost of debt capital found for United Gas Pipe Line Company of 4.85% were used, the rate resulting

(281)

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for the common stock equity by the residue method would fall further to 8.98%.

(End Page 12)

Similarly, as set forth in the upper section of Schedule 5, if the December 31, 1961 capital structure ratios were used the results would be 9.17%, 8.97% and 8.67% under the same alternative 4.44%, 4.60% and 4.85% debt capital cost applications, as compared with the 10.28% presented in Staff Supplemental Exhibit, page 1.

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Excerpts from testimony of E. L. Dunn a witness for UGPL Co.

Direct Examination

Q. Will you please proceed as to the additional schedules?

A. Yes. Before explaining the content of Schedule H(3)-3-(a) I should point out that United Gas Pipe Line Company (United) is included in a consolidated federal income tax return as the wholly-owned subsidiary of its parent corporation, United Gas Corporation (Gas Corporation). Union Producing Company (Union) is also included in the same consolidated return as a wholly-owned subsidiary of its parent corporation, Gas Corporation. A number of other so-called name-saving companies are also included in the consolidated return, but these companies contribute no income or loss to the consolidated income. Specifically Schedule H(3)-3-(a) shows for the taxable year 1960, the most recent year for which a return has been filed, the computation of consolidated net taxable income for the three corporations to which I have referred as well as the

computation of the consolidated system tax liability. Also shown at the foot of the schedule are the details of the consolidating adjustments.

(End of Page 6)

Q. Do you have any further comments in respect of Schedule H(3)-3-(a)?

A. Yes, but I would prefer to reserve these comments for a later point in my testimony where I intend to discuss

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Q. Will you please state as to what particular point your comments will be directed?

A. Yes. The comments which I am about to make relate to the matter of determination of the federal income tax expense includible in cost of service of United for the test period.

Q. Will you please proceed?

A. As indicated by Schedule H(3)-a, the amount of federal income taxes included in cost of service for the text year has been computed on United's net taxable income for the year at the statutory rate of 52%. As to the propriety of the use of the 52% rate I should like, at the outset,

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to make a general observation. It is recognized rate procedure that in the determination of cost of service for the purpose of establishing appropriate rates only the revenues and deductions of the company the rates of which are under

consideration be used and that non-current, non-recurring, out-of-period, and non-utility items of a substantial nature must be eliminated in the determination of such cost. Consistency demands that the federal income tax allowance includible in and made a part of such cost of service be determined on the same basis. The amount of federal income tax results from two things: (1) a properly determined amount of taxable income to which the tax rate is to be applied, and (2) the tax rate itself. In the determination of taxable income the same procedure as I have

(End of Page 11)

just outlined for cost of service is followed. To apply to such taxable income a rate of tax developed by application of the so-called consolidated return tax savings theory would be inconsistent with the rate making principle otherwise followed.

Q. In what way would the use of such a tax rate be inconsistent?

A. To understand this one must understand that the period of time during which revenues and deductions may be used in determining taxable income in a federal income tax

return is controlled by provisions of the Internal Revenue Code. Quite often the timing for tax purposes does not coincide with the timing for book accounting nor with rate making requirements. An example of this is explained later in my testimony in respect of federal income tax for 1961. Further, the Revenue Code often requires the inclusion in or exclusion from taxable income of items of revenue or deductions which must be treated differently for book accounting and rate making purposes. Finally, in a consoli-

dated tax return the revenues and deductions of several companies are combined into a single amount of net taxable income. Therefore, the use for rate making purposes of a tax rate developed by application of the so-called consolidated tax return savings theory would apply a tax rate in determination of federal income tax included in cost of service that is affected by items included in the consolidated tax return which are unrelated to and have no bearing on the regulated gas business. Some examples of such items are:

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(1) Inter-company transactions between non-utility members of the group filing a consolidated return not affecting in any way the regulated company nor the consolidated tax allocated to and paid by such company.

(2) Capital gains and losses which have nothing whatsoever to do with the regulated gas business.

(3) Non-operating, non-recurring, non-jurisdictional, and out-of-period expenses, losses, or gains and income not taken into account in establishing cost of service and return included therein, and

(4) Income and deductions of other companies.

These items on the one hand are properly includible in the consolidated tax return in order to comply with the provisions of the Internal Revenue Code and in some cases they produce a loss for a given company in the consolidated group which superficially at least seems to produce a so-called tax saving to other companies contributing income to the consolidated group taxable income. But where these items are disregarded in the rate making

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procedure, if they are not disregarded for all purposes of such procedure including the proper tax rate to be applied in the computation of federal tax expense includible in cost of service, an inconsistent, distorted result follows which is not compatible with proper regulatory procedure consistently applied.

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And, second, is the fact that in the computation of the consolidated tax the so-called 2% tax penalty provided by law for the filing of a consolidated return must be applied to Union's taxable income included as part of the consolidated taxable net income for 1962 since Union is not a regulated public utility within the meaning of the tax law. United, of course, is a regulated company under the tax statute and for this reason the 2% consolidated return tax penalty does not apply to its taxable income.

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The third reason is that it is also a fact that under the tax law any Union net loss which is a part of the consolidated taxable income in the return filed by the United

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Gas group and which loss is not utilizable to Union as a carry-over or carry-back on a separate return basis must be applied in reduction of the tax cost basis of Gas Corporation's investment in the securities of Union. Union has sustained losses of this character which are substantial in aggregate amount but as to which I have made no precise computation. The significance of this effect of the tax law is in the

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fact that such effect gives rise to, as to Gas Corporation, a potential tax liability in some future year should Gas Corporation dispose of its investment in Union either by outright disposition to third parties or by the process of the retirement of Union's indebtedness as between Gas Corporation and Union; or alternatively, when Gas Corporation receives from Union dividends which for tax purposes are deemed as distributions not out of Union's earnings and profits and as such are applied in reduction of the tax cost to Gas Corporation of Union's stock investment.

Q. Will you please amplify the latter part of your answer respecting the tax effect of certain dividends paid by Union to Gas Corporation?

A. As I stated in my last previous answer, not only do losses of Union non-utilizable as carry-backs or carry-overs operate to reduce the tax cost basis of Gas Corporation's investment in the securities of Union but the same effect occurs also as to any dividends Union pays which for tax purposes are considered as distributions not out of Union's earnings and profits. As I have stated, the combination of these two

(End of Page 23)

factors operates to reduce Gas Corporation's tax cost basis of its investment in the stock of Union. When that basis reaches zero any further Union dividend distributions of

this character must be included in taxable income of Gas Corporation as capital gains. Dividends aggregating $25,632,970 for the four-year period, 1957 to 1960, inclusive, have been paid by Union to Gas Corporation which for tax purposes are distributions which must be applied to reduce the tax cost basis of Union's stock in the hands of Gas Corporation. Thus, under operation of the tax law and regulations these Union deficits in taxable income do in literal, ultimate effect increase taxable income either to Gas Corporation or to Union.

Q. You have testified that under specified circumstances the application of Union's net losses in reduction of Gas Corporation's investment in the securities of Union could ultimately bring about taxable income to Union. Can you amplify this point?

A. Yes. As I have stated, under appropriate circumstances which I have described, Union's losses as well as certain dividend distributions by Union to Gas Corporation must for tax purposes be applied by Gas Corporation to reduce the tax cost of Union's stock in the hands of Gas Corporation. When that basis reaches zero any further Union losses are applied under the tax rules to reduction of the tax cost of Gas Corporation's investment in the debt securities of Union. Thereupon when Union retires such indebtedness, under

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consolidated return rules, the difference between the reduced tax cost basis of the debt to Gas Corporation and its principal amount would be taxable income to Union and before part of consolidated taxable income in the year of such debt retirement.

Q. How do the tax results to which you have testified bear upon the question of the effect of the inclusion of Union's loss in the filing of a consolidated tax return?

A. All that which I have here pointed out should be considered against the background of this significant fact, to wit: Gas Corporation's investment in stock and debt of Union, together with Union's internally generated cash necessarily have financed the Union deficits in taxable income here discussed. This follows because Union's stock and debt securities are held entirely by Gas Corporation. United's customers did not supply the money used for the expenditures which gave rise to these deficits in Union's taxable income. Likewise none of Union's investment in plant and property is included in United's rate base. Neither are any of Union's expenses included in United's cost of service in this proceeding.

But an application of the so-called consolidated return tax savings to United would give that company's customers the benefit thereof although none of the money required to finance Union's operations was supplied by United's customers nor did they take any risks inherent in such operations

nor were they charged for any part of Union's operating expenses or a return on its investment in plant.

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Hence, as I have said at the outset, the result described further supports a determination of United's cost of service federal income tax expense at the rate of 52 per cent without regard to any of the tax effects which may arise from the inclusion of Union or any other loss company in a consolidated tax return which also includes United.

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Q. Earlier in your testimony in respect of Schedules H(3)-3-(b) and (c) you develop the point that because of Union's loss carry-overs Union will not be called upon to pay any part of the consolidated tax for the years 1961 and 1962 even though in such years Union contributes taxable income to the consolidated taxable net income. Isn't that correct?

A. That is correct.

Q. You have also testified that the 1961 and 1962 allocation of the consolidated tax results in assignment of all of the consolidated tax to United with a consequent tax payment by United in an amount in excess of the statutory

rate applied to United's taxable income. Isn't that true?

A. Yes, that is true, if for the year 1961 due adjustment is made in computing the consolidated taxable income so that there is recognition of non-recurring, non-utility and out-of-period items as to which I have testified in some detail.

Q. Does this mean then that United in effect in 1961 and 1962 would be paying for a part of the benefit of the earlier year net losses of Union?

A. Generally speaking, that is true.

Q. Why does this result follow in light of your earlier testimony that it is Gas Corporation which in ultimate effect will have to bear the later tax burdens which arise out of the earlier

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tax benefits brought about by the utilization of Union's losses in a consolidated return? As I understood your testimony it is United which in 1961 and 1962 at least is bearing the burden.

A. Your understanding is correct. Gas Corporation, in the allocation of the consolidated tax for the years during which Union contributes a loss is not assigned the full benefit of that loss since a portion of it is assigned to United through the procedure of allocation of the consolidated tax to United as well as a portion to Gas Corporation where both companies contribute a taxable income to the consolidated net

taxable income. Although we recognize the result I have described and are aware that some other allocation could be used for book accounting purposes, we felt it is better to allocate the consolidated tax in accordance with the rules prescribed by the tax law in the computation of earnings and profits of the respective companies which are included in the consolidated return. This method of consolidated tax allocation for income tax earnings and profits is authorized by Section 1552(a)(1) of the Internal Revenue Code and the use of this method enables us to establish the earnings and profits of the respective companies. These tax earnings and profits, as I have previously testified, are determinative of the tax status of inter-company dividends paid by the subsidiary companies to the parent company. But I know of nothing in these tax law provisions which has even a remote bearing on the tax calculation procedures necessary in establishing

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federal income tax cost of a regulated company to be included in its cost of service where such company files its tax return as part of a consolidated group and its income in the computation of the consolidated tax is co-mingled with the income of other companies, certain of which have non-utility, non-regulated income and losses unrelated to the regulated company.

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Q. In the light of your testimony, would you say that the allocation of consolidated tax has any bearing upon the proper determination of allowable federal income tax of a regulated company for cost of service purposes?

A. No.

Q. Will you state your reasons for your answer?

A. Yes. It has seemed to us that it is not necessary to make cash payments representing adjustment of tax as between one company and another in the consolidated group. This result holds even though certain effects arise as to carry-over or carry-back of net losses from one year to another. The reason is that in ultimate result it is the parent company's investment in the subsidiary companies through its equity interest in such subsidiaries which bears the cost of utilization of the losses in the consolidated return as I have previously testified, and there is no need to engage in a series of inter-company cash transactions where the overall and ultimate effect inures in any event to the parent company stockholders, as it should. The procedure which I have described in allocation of consolidated tax under the

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inter-corporate capital structure of the United Gas group simply cuts through the distortions and imbalances inevitably associated with assignment of the consolidated tax under an

inflexible and unchanging method. Further it recognizes that if so-called savings under the allocation method employed do go in one direction and associated tax burdens in another all these effects merely influence equity, and equity alone, and thus the tax burdens and the tax benefits converge to the parent company and its stockholders. The conclusion is that all the burdens and benefits refer-

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able to the regulated company's operations should be and are taken into account in the 52 per cent rate computation for rate making purposes, and all other tax burdens and benefits of the consolidated group not related to the regulated company pass to the stockholders to whom they belong.

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Excerpts from Rebuttal Testimony of E. L. Dunn, a witness for United Gas Pipe Line Co.

Q. Are you the same W. G. Meece who testified on direct examination in this proceeding?

A. Yes, I am.

Q. I show you an exhibit titled "United Gas Pipe Line Company Summary of Taxable Income — Years 1957 to 1961, Inclusive, Restated to Reflect Certain Adjustments as Indicated by Detailed Schedules." Was this Exhibit No. 14-1, for identification, prepared by you or under your direction?

A. Yes, it was.

Q. Will you explain this exhibit?

A. This exhibit contains data pertaining to the Consolidated Federal Income tax returns of United Gas Corporation and subsidiaries for the years 1957, 1958, 1959, 1960 and 1961. The purpose and results shown by the various schedules will be discussed later in my testimony.

Q. In your direct testimony in this proceeding, Mr. Meece, you stated that the amount of federal income taxes included in cost of service as determined by United Gas Pipe Line Company (United) for the test year has been computed on United's net taxable income for the year at the statutory rate of 52 percent. Is this correct?

A. Yes.

Q. Have you read the testimony of Staff witnesses

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Warner and Brinn and the testimony of Memphis witnesses Smith and Rowe as presented in this proceeding?

A. Yes.

Q. Have you examined Exhibits 19-1 and 19-2, which Staff Witness Warner sponsored and Exhibit 23, which Memphis Witness Smith sponsored?

A. Yes.

Q. As to the tax rate do the testimony and exhibits of the Staff and Memphis to which I have just referred state a conclusion in accord with the statements you have made in your direct testimony?

A. No.

Q. Will you summarize in what respects the Staff and Memphis witnesses differ with you on the point of the tax rate to be applied?

A. The Staff and Memphis testimony and exhibits to which you refer, in general, apply the so-called effective rate procedure in the determination of federal income tax expense includible in cost of service.

Q. Will you describe briefly the technique employed by these witnesses in applying the effective rate method in ascertainment of federal income tax expense?

A. Yes. United is included in a consolidated federal income tax return filed by United's parent, United Gas Corporation (Gas Corporation), in which return also are

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included Gas Corporation's

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wholly-owned subsidiaries, Union Producing Company and United Overseas Production Corporation. When one or

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more of the corporations included in a consolidated income tax return report a net loss for tax purposes, such loss operates to reduce consolidated taxable income with corresponding effect upon the consolidated tax. The effective rate derives from assigning to the separate companies included in the consolidated return which show taxable income a part of the so-called saving which arises as a result of the deduction from consolidated taxable income of the loss or losses shown by other affiliates.

Q. Will you explain in somewhat greater detail the method employed by the Staff and Memphis witnesses in determining the effective rate which they claim should be applied for the purpose of calculating the federal income tax expense component?

A. An effective rate determination was made, following generally the method which I have previously described, for each of five years prior to 1962, using for this purpose the amounts of taxable income derived from the consolidated tax returns filed by Gas Corporation and its affiliates, of which United is one. The effective rate determination to which Staff Witness Warner has testified is shown by Schedule No. 5

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of Exhibit 19-1 presented by him in support of his testimony. The effective rate determination made by the Memphis Witness Smith is shown by Schedule No. 6 of Exhibit 23 filed by that witness in support

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of his testimony. In the Warner exhibit a five-year average from 1956 through 1960 is used while in the Smith exhibit a five-year average from 1957 through 1961 is employed. The

Warner exhibit thus develops a five-year average effective tax rate of 49.81 percent. The Smith exhibit shows two figures as an average effective rate — one which is an average determined by totalling the taxable income of United alone for the five-year period used by Smith and dividing such aggregate taxable income by the aggregate amount of allocated tax for the same period which produces a so-called effective rate of 48.537 percent and the Smith exhibit also shows an arithmetical average of the effective rates for the five years of 48.001 percent. In utilizing the effective rate for the purposes of his testimony Mr. Smith has employed the effective rate of 48.537 percent. Staff Witness Warner, while reaching an effective rate figure of 49.81 percent, has utilized an effective rate figure of 49.69 percent for other computations in his testimony. There is no apparent explanation for this slight difference in rate used by the staff witness.

Q. Do you consider that the so-called effective rate

method of determining the federal income tax component for United is correct?

A. No. I have referred to the matter of the use of an effective rate for the purposes of this proceeding in my direct testimony and I have testified that it does not produce a correct result. The reasons for my conclusion have been stated at some length in my direct testimony.

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Q. You have testified that the effective rate theory arises solely because of the filing of a consolidated income tax

return in which United has been included as a subsidiary. Is this correct?

A. Yes.

Q. Will you state the various companies which have been included in the consolidated return for the years referred to in the Warner and Smith exhibits and in general give a description of their operations?

A. During each of the years referred to in the Warner and Smith exhibits the consolidated federal income tax return filed by United Gas Corporation included United Gas Corporation, United Gas Pipe Line Company, and Union Producing Company (Union), and certain so-called name saving companies which have no income or expense and are not germane to this discussion. Beginning with the year 1961 the consolidated return has also included United Gas Corporation's wholly owned

subsidiary United Overseas Production Corporation (Overseas). Gas Corporation is the parent company of the group; it owns all of the capital stock and all of the outstanding long-term indebtedness of each of the subsidiary companies. Gas Corporation also owns and operates natural gas distribution systems in various areas of Texas, Louisiana, and Mississippi. The income of Gas Corporation from which arises the taxable income reported by that company in the consolidated return is derived from its distribution operations plus the interest and dividends which it receives from its subsidiaries, and also

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dividends and interest which it receives from investments in other companies not included or includible in the consolidated return. United's taxable income is derived from the operation of its pipe lines and gasoline extraction plants and certain minor miscellaneous income. The income it receives from these operations is reduced by the expense incurred in conducting such operations and by the interest which it pays on its indebtedness to its parent company, in determination of taxable income included in the consolidated return. Union is engaged in the business of the exploration, development, and operation of both natural gas and oil properties. Its revenues are derived from the sale of natural gas and oil as produced. Only a part of the natural gas produced by Union

is sold to United. Union's taxable income is determined by deducting from the gross revenues it receives from the sale of oil and gas, its expenses of operation as well as certain other deductions permitted for tax purposes in the computation of Union's taxable income. In general the latter category includes deductions for intangible drilling expense, percentage depletion, depreciation as ascertained for tax purposes and like items. Beginning with the year 1961 Overseas, a newly organized wholly-owned subsidiary of Gas Corporation, was included in the consolidated return. The operations of this company are conducted entirely outside the United States and at the present time consist of participation in an oil exploration project in Tunisia, North Africa. For the year

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1961 it reported a net loss for tax purposes. Consolidated taxable income for the group is the sum of the taxable income figures of each company in the group less elimination of intercompany dividends and certain other minor intercompany adjustments.

Q. To what extent are the rates of Gas Corporation and its subsidiaries participating in the consolidated return regulated by any State or federal commission?

A. With respect to Gas Corporation in its distribution operations, its rates are subject to regulation in Mississippi by the Mississippi Public Service Commission, in Louisiana

by the Louisiana Public Service Commission, and in Texas by the municipalities it serves and the Texas Railroad Commission.

With respect to United, its rates are regulated by the Federal Power Commission insofar as they concern sales made under tariffs filed with that Commission. In addition, certain sales by United for resale at town borders in Louisiana are regulated by the Louisiana Public Service Commission and certain similar sales in Texas are subject to regulation by the Texas Railroad Commission. Direct sales by United to industrial customers are generally not regulated.

With respect to Union, rates for sales of natural gas pursuant to contracts filed with the Commission are subject to its regulation. Union's sales of oil and other related products are not regulated.

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There is, of course, no regulation involved in certain activities of the parent company, Gas Corporation, such as the sale of merchandise and performance of appliance repair services, research and sale in respect of various types of instruments useful generally in the natural gas industry, and the receipt of interest and dividends on investments.

Q. Reverting to the matter of the determination of an effective rate as shown by the exhibits filed by Messrs. Warner and Smith, and assuming only for the purpose of this

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question that (a) the effective rate method is an acceptable technique for the purpose intended, and (b) the five-year average technique is an appropriate one for the purpose intended, do you have any comment in respect of the application of the method itself as developed in the Warner and Smith exhibits?

A. Yes.

Q. Will you please state such comments?

A. I should like to make the following points which apply directly to the computations used in Warner Exhibit 19-1 and Smith Exhibit 23. My first point relates to the figures of taxable income shown for each year which were those derived, in the case of the years 1958 through 1961, from the consolidated returns filed for the respective years. These returns are subject to the usual routine examination by the Internal Revenue Service and as to certain years revenue agent audit adjustments have been made which change the figures of taxable income. Further adjustments have been made by the Internal

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Revenue Service in respect of the years 1956 and 1957, which are not reflected in the Staff and Memphis exhibits. For the intended purpose and subject to the assumptions you have stated, I would say that the figures as shown by the revenue agents' reports for the various companies as to the years in

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respect of which Internal Revenue Service examinations have been completed should be used since these supersede the tax return figures. As to the years here concerned, the consolidated tax returns have been examined for each of the years 1956 through 1959, inclusive.

Q. Does your exhibit show the figures you consider to be correct for the purpose and under the assumptions previously stated?

A. Yes.

Q. Do you have other comments to make in respect of the subject under consideration?

A. Yes. The second point is that the consolidated taxable income figures in any event should not include the result of Union's oil operations.

Q. Will you state your reasons for your response to the last previous question?

A. The oil operations of Union are wholly outside of the jurisdiction of the Federal Power Commission. Union's oil operations do not have even a remote bearing upon the determination of proper rates for the sale of gas within the jurisdictional authority of any regulatory commission. No part of the cost of such oil operations by Union is chargeable to United's customers, and in no way do these

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operations affect the costs chargeable to United's customers.

Union's oil operations are non-regulated and unrelated to the activities of United. It appears entirely appropriate, therefore, that even if the effective rate technique were applied in this case, it should be applied in such manner so that taxable income figures in any case would not include any taxable income or loss figures arising from Union's oil operations. My Exhibit 14-1 shows for each of the years 1957 to 1961, inclusive, the taxable income or tax loss result in respect of the oil operations of Union as distinguished from such income or loss arising from Union's gas operations. The amounts of such taxable income or net loss for tax purposes in respect of Union's oil operations is shown in the Schedules 8 to 12.

Q. Do you have further comments?

A. The figures of taxable income used in the Warner and Smith exhibits should also be adjusted in respect of the following items:

(a) The taxable income of Gas Corporation should be restated for each year affected by the 1961 rate refund which Gas Corporation was called upon to make as result of the decision of the Mississippi Public Service Commission, and the taxable income of Gas Corporation and United should be restated for each year affected by the 1962 rate refunds directed by the Federal Power Commission and agreed upon by United in Docket No. G-9547, et al.

(b) The taxable income of United should be increased for the year 1961 by the amount of $6,082,138 and for the year 1960 by the amount of $769,850 representing elimination of deductions taken in the returns as filed for said

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years for gas prepayments made or due under take or pay gas purchase contracts.

(c) The addition to taxable income by way of elimination of the amount of the interest deduction which arose in respect of the gas rate refunds made by Gas Corporation during the year 1961.

(d) The addition to taxable income of the amount of $24,354 representing elimination of the loss deducted in the 1961 return attributable to the operation of Overseas, a company the activities of which are non-regulated and unrelated to the activities of United.

Q. Will you explain your reasons why you believe to be correct the adjustments referred to in your answer as (a), (b), (c), and (d).

A. As to adjustment (a): If the five-year average technique is to be employed in establishing a tax rate which is to be applied for rate determination purposes applicable to future years, the income figures of the five-year period should be stated on a basis which reflects the facts and conditions as they are known today affecting the

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taxable income of the respective companies for the respective years. Hence, for the purpose intended it appears appropriate that adjustment be made reflecting rate refunds by Gas Corporation and by United in the various years to which such refunds are known to apply. As to adjustment (b): The deductions taken in the 1960 and 1961 returns for gas prepayments, that is, the deductions relating to take or pay gas purchase contracts; were so taken because of the technical requirement of the tax law to the effect that a liability must be accrued and deduction taken therefor in

the year when the fact of such liability is established and the amount thereof can be determined with reasonable accuracy. This rule, while technical in nature, is nevertheless an important tax rule and must be observed in order to avoid possible future adverse tax consequences. However, on the books of account these items were treated as deferred charges, and they have not been included in cost of service to the ratepayer for the year during which the deductions had to be taken for tax purposes nor in the test year cost of service in this proceeding. Therefore, no part of the reduction of tax brought about by the deductions should affect the federal income tax expense component for the cost of service in this proceeding. Of course, as either gas taken in makeup occurs or there is a forfeiture of the gas prepayment and to the extent that such makeup or forfeiture is chargeable to

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the ratepayer, an appropriate counter adjustment in federal income tax expense necessarily must be made. As to adjustment (c): The interest expense incurred by Gas Corporation as a part of the gas rate refund is in no

(End of Page 12)

way chargeable to the customer but is a charge which in fact has come out of the pocket of Gas Corporation's stockholders, hence there is no basis for assigning any part of the reduction of tax because of such interest expense to United's ratepayers. As to adjustment (d): The loss operation of Overseas, an unregulated company, is in no way related to the activities of United and under no theory is it chargeable to the customer, but rather is a charge which again comes out of the pocket of Gas Corporation's stockholders, therefore there is no basis for assigning any reduction in tax as a result of such loss to United's ratepayers.

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Q. As to the comments you have made in reference to the exhibit you have presented, will you please identify the schedules in which appear the various items you have described?

A. The items upon which I have commented appear in Schedules Nos. 3 to 7, inclusive.

Q. Do you have any other comments in respect of Exhibit 14-1 you have filed?

A. Yes. I would like to comment briefly concerning the figures which appear on Schedule No. 1 of my exhibit.

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These figures show a tabulation of the taxable income of United and the portion of the related consolidated tax allocated to United for each of the years 1957 to 1961, inclusive, with a resulting "effective rate" as to each year. The schedule also shows an arithmetical average of the taxable income figures for the five-year period and a similar arithmetical average of the portion of the consolidated tax allocated to United

(End of Page 13)

for the five-year period. By dividing the averaged taxable income by the averaged tax figure, a mathematical result of 51.749 percent is obtained characterized by the Staff and Memphis witnesses as a weighted average effective tax rate. In presenting this schedule, I should like to make it clear that I do not suggest that this is a proper way to compute an "effective rate" on a five-year average basis; but my Schedule No. 1 has been presented in this form solely for purpose of comparison with schedules presented by Staff and Memphis witnesses which show five-year average effective rate computations made on the same basis as shown by Schedule 1 of my exhibit. The data which appear on Schedule No. one of my exhibit are derived from Schedules Nos.

3 to 7, inclusive, of the same exhibit. The latter schedules show the various adjusments which I have previously described in detail.

Q. In your answer you stated that the method which,

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appears on Schedule No. 1 described by Staff and Memphis witnesses as a weighted average method, is not the proper way to compute a five-year average "effective rate" if an "effective rate" is to be determined. Will you state what you believe to be a proper way to compute a five-year average "effective rate," if one is to be used?

A. The computations which appear on Schedule No. 2 of my exhibit demonstrate the proper method to be employed in computing an "effective rate" based on a five-year average. The appropriate starting point for a correct five-year average tax rate is the average of taxable income for the five-year period for each of the companies in the consolidated return during such period. This

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average is shown in Schedule No. 2 for each company and these separate company taxable income figures when aggregated in the conventional manner produce a consolidated taxable income on an average basis. At this point I should like to emphasize that the amount of income tax expense is a result of two elements, to-wit: Taxable income and the tax rate. The tax rate when applied to taxable income produces the amount of income tax expense. On Schedule No. 2 the statutory rate of 52 percent is applied to consolidated taxable income. The resulting consolidated tax is then allocated to the individual companies on the ratio of each company's separate company

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taxable income to the "aggregate consolidated taxable in-

come of companies having taxable income." Since each of the companies on Schedule No. 2 has taxable income included in consolidated taxable income at the 52 percent rate, the "effective rate" as to the portion of the consolidated tax allocated to each company is, of course, 52 percent. Hence, if federal income tax expense is to be determined by use of an effective rate, calculated on an average basis, the only averaging which should take place is that of the taxable income itself and nothing else. This demonstration shows that even under the five-year average technique and without taking into account such items as non-utility losses and the like included in the figures used, the effective rate on an overall properly computed weighted average basis for the five-year period still remains at 52 percent, which, of course, is the rate which we have claimed should be used in the computation of the federal tax expense component.

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Q. Referring to the exhibit entitled "Computation of Federal Income Tax Alternate Methods," submitted by Staff Witness Warner as part of his testimony, specifically Schedule No. 1 thereof, you have commented earlier in your testimony upon the use of the effective rate of 49.69 percent of taxable income in the computation of the amount of federal income tax expense proposed by the Staff as part of the cost of

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service. Do you have any further comments concerning the application of this rate when applied to the taxable income of United?

A. Yes. Since the statutory tax rate is 52 percent, the use of a lower so-called effective rate has the effect of ascribing to United tax deductions, which when applied

in reduction of United's taxable income would produce the same amount of tax computed at the statutory 52 percent rate as is produced by use of the 49.69 percent rate when applied to United's taxable income without such deductions.

Q. Will you please amplify your explanation on this point?

A. The taxable income of United used for the purpose of computing federal income tax expense includible in cost of service takes into account all of the deductions to which United is entitled in its own right, excluding, of course, those deductions to which I have previously referred as to which adjustment should be made for a proper result for the purpose of this proceeding. Further tax deductions, when applied in computation of United's taxable income, would reduce such income so that when the statutory rate of 52 percent is applied thereto the result in terms of amount of tax would be the same as the effective

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tax rate of 49.69 percent when applied to United's taxable

income without benefit of these extra deductions. This means that the effect of applying a tax rate lower than the statutory 52 percent rate in establishing the federal income tax expense component is to ascribe to United the tax benefit of deductions from a source other than those arising in respect of its own corporate operations. A simple example will demonstrate my point here. Assume an established taxable income figure of $1,000. An effective rate of, say, 48 percent applied to this income produces a tax of $480. But as I have previously testified, income tax expense can only be the result of taxable income times tax rate. The corporate tax rate applicable

by law to United is 52 percent. A tax of $480 and a tax rate of 52 percent means taxable income of $923 (i.e. $923 x 52 percent equals $480). Thus an estimated taxable income figure of $1,000 becomes $77 less, or $923 under the effective rate technique. The Warner Exhibit No. 19-1, Schedule No. 1, if modified to eliminate the investment credit adjustment of $2,100,000, will produce a taxable income figure of approximately $21,545,000. This figure is obtained by applying the conventional percentage factors as shown on the Warner Schedule No. 1 to the 6½% percent return and tax deduction figures indicated on that schedule. The resulting tax at the Warner Schedule effective rate of 49.69 percent is $10,700,174 as shown by my Exhibit 14-5, titled "Computation of Federal Income Tax in Docket RP63-1 using Staff

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Witness Warner's Formula." This amount of tax at a 52 percent tax rate represents taxable income of approximately $20,577,000. Thus the established taxable income figure of $21,545,000 becomes $968,000 less under the 49.69 percent effective rate.

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Using the same taxable income figure of $21,545,000 but applying thereto the Smith effective rate of 48.537 percent the resulting tax amount is $10,457,000. At the 52 percent tax rate this tax amount represents taxable income of approximately $20,110,000. Hence, the reduction in the established taxable income figure of $21,545,000 is $1,435,000.

In other words, by use of the respective effective tax rates of 49.69 percent and 48.537 percent applied to the taxable income figure derived from the Warner exhibit as I have described, United's customers would be given

the benefit of theoretical tax deductions from sources other than United's own operations of between $968,000 and $1,435,000 depending upon the effective rate applied.

Q. You say that the indicated theoretical deductions given to United on the basis you have outlined would derive from sources other than United's own operations. What other sources would be available from which such a deduction could be secured?

A. The only other source for such deductions would be to impute to United tax deductions which in fact are those of

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one or more of United's affiliates included with it in the consolidated returns filed. But under the Staff and Memphis witnesses' five-year average method of computing the effective tax rate, I would like to point out that the taxable income of Union and Gas Corporation on the same five-year average basis is not a loss figure but is in fact an income figure, as shown on Schedule No. 2 of my exhibit. Therefore, the indicated fictitious tax deductions which must come from some other-

(End of Page 18)

source for the benefit of United simply are non-existent. The only other conclusion which can be drawn from this analysis of the real effect of use of the effective rate technique is that the Staff and Memphis are assuming that such losses will arise in the future as a regular recurring circumstance and if they arise can be imputed to United. There is, of course, no basis in fact for such an assumption. Thus these are phantom tax deductions.

Q. Would the same amount of phantom tax deductions arise if any of the additional tax deduction adjustments claimed in the Warner and Smith exhibits were allowed in

computing taxable income for federal tax expense component purposes?

A. The phantom deductions would arise, but not in the same amount. True to their phantom-like character they would vary with the amount of taxable income ascertained under any

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given assumption as to allowable tax deductions. This of course is further indication of the fallacy of the whole effective rate technique.

Q. In addition to the adjustments indicated by your Exhibit No. 14-1 have the figures there shown been adjusted for any other items which you would consider appropriate?

A. No. In the interest of avoiding undue complication we have not undertaken to show the effect of the elimination as deductions of such non-utility losses as those arising from Gas Corporation's merchandise and jobbing department and its instruments division. There are other similar items.

(End of Page 19)

Q. Why, in your figures, have you not made adjustments for these items?

A. They have been omitted largely in the interest of a simplified presentation. But by such omission I do not wish to convey the impression that in our view appropriate adjustment for such items in determination of the federal tax expense component should not be made. The exhibit and schedules to which you refer have been presented for the purpose of demonstrating the invalidity of

the effective rate technique. We believe this objective has been accomplished by the exhibit without resorting to refinements of further but nevertheless appropriate adjustments.

Q. Earlier in your testimony you explained that the

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inclusion of the losses of Union in the consolidated returns filed by Gas Corporation and its subsidiaries are generally responsible for the so-called effective rate result which the Commission Staff and Memphis seek to apply. Is this correct?

A. Yes.

Q. Do you have any further comment concerning the effect of Union's losses upon the consolidated tax return?

A. I would like to point out that whatever amount may be included in cost of service as to United for gas purchased by it from Union necessarily must include recognition of Union's federal income tax expense component in the cost of such gas. I am aware that Staff counsel has made the observation that no allowance should be made for such cost factor since Union, according to Staff counsel, has a tax liability only about once every five years. I do not agree

(End of Page 20)

with the Staff's position on this point but if there is no federal tax component recognized in the cost of gas purchased by United from Union, its omission is due to Union's net loss for tax purposes. As the schedules show, which are a part of the exhibit I have presented, Union's tax net loss should be segregated in the first instance be-

tween Union's oil and gas operations, respectively. Furthermore, the loss attributable to Union's gas operations is completely absorbed by Union's

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taxable income from such operations in other years during the five-year average period used by the Staff to establish an effective tax rate. It must follow from this that no part of Union's gas operation tax losses should affect the tax rate applicable to United's taxable income. This, of course, is only another way of pointing out the fallacy of any federal income tax rate applicable to United's taxable income other than the statutory rate of 52 percent. And, finally, not all of Union's losses in any event are referable to its jurisdictional gas sales since about 25 percent of Union's gas revenues are derived from non-jurisdictional sales.

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Excerpts from testimony of E. L. Dunn, a witness for UGPL Co.

Cross-Examination

BY MR. BERKELEY:

Q. Mr. Dunn, is it not correct that United Gas Pipe Line Company does not file a separate income tax return, but rather joins in a consolidated income tax return which includes United Gas Corporation, United Gas Pipe Line, and Union Producing Company?

A. I believe that is fully explained on my direct, but each of the companies in a consolidated return do prepare a separate return, and then it is consolidated to form a consolidated return.

Q. But the actual dollars of tax paid by United Gas Pipe Line, or any other constituent member of the consolidated tax filing group are determined by the taxable income after inter-company eliminations shown on the consolidated tax return, is that correct, sir?

A. I don't believe that is the way the law is. Each company is fully liable for its own taxes in the consolidated group.

Q. Is it not a fact, Mr. Dunn, that if you want to know the total dollars of tax paid by UG Corp., Union Producing and United Gas Pipe Line, you must look to the total consolidated

tax income and total consolidated tax shown in the consolidated return?

A. Would you read that, please?

(The question was read.)

THE WITNESS: Well, you have taken three companies and added them together to get a total. Now, the consolidated tax shows the consolidated total tax.

BY MR. BERKELEY:

Q. All right, sir. You said before that each of the three companies prepares a separate tax return?

A. Yes.

Q. On that separate tax return there will be a figure called net taxable income for United Gas Pipe Line, and

there will be another one for Union Producing, net taxable income of Union Producing, and another for United Gas Corporation, excluding, now, years beginning in 1961 when you have Union Producing Overseas — ignoring them, you add the other three together. Those separate net taxable figures will always be greater than the amount of consolidated tax income and tax shown on the consolidated tax return, is that not correct?

A. That is not necessarily true.

Q. Can you cite me to a year in which it was not true?

A. Well, I would have to go back and check prior years, out obviously —

Q. I am agreeable to your supplying the information.

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A. Obviously, it cannot always be true, because any non-regulated company is subject to a two percent penalty in filing or joining in a consolidated return, so that it is not necessarily true under the tax laws that filing a consolidated return makes the total tax less for all the companies on a consolidated basis than it would be for the companies on a separate return basis.

Q. Is there any other reason you could give to support your statement other than the two percent penalty applicable only to Union Producing Company?

A. No, I can't think of any reason why the consolidated total tax should be any different from the three separate returns tax except the savings of fifteen percent of inter-company dividends, and the fact that in any one year the total tax does not reflect the right of the indi-

vidual companies to carry forward or carry back tax losses.

Q. All right, now, turning back to the question of the two percent penalty, do you know the maximum dollar amount of the two percent penalty because Union Producing, which is not a regulated company, participated in the consolidated tax return in any year between 1956 and 1961, and by "maximum" I mean the greatest amount in any of those years, the greatest dollar amount.

A. Well, it may well be shown on the detailed material we furnished, but I can't recall offhand. It is two percent of

their taxable income.

Q. What was the highest taxable income that Union Producing Company had in any of those five years, Mr. Dunn?

A. Well, again that is shown on my exhibits.

Q. Which exhibit, sir? I would like to look at it.

A. I believe the highest year in the last few years was in 1958.—

Q. Excuse me, Mr. Dunn, I asked for the period '56 to '61, the highest in that period.

A. Well, in that period, it would be the year '58.

Q. All right, sir, which exhibit are you looking at now?

A. Exhibit 14-1, Schedule 9.

Q. Well, if I understand Schedule 9 correctly, it is the amounts attributable to oil and gas.

(2811)

A. Well, it is the total, alto — total taxable income for the year 1958 for Union is $4,996,503. That is shown in the lower righthand corner.

MR. SPIEGEL: Can you give us the line and column in that, sir?

THE WITNESS: Well, it is Column 9, line 36.

MR. SPIEGEL: And that is Schedule 9?

THE WITNESS: Schedule 9.

MR. SPIEGEL: Will you give us just a moment to find these things?

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PRESIDING EXAMINER: Yes.

BY MR. BERKELEY:

Q. Would you accept subject to check, Mr. Dunn, that two percent of that highest maximum taxable income reported by Union Producing in the five years between 1956 and 1961 is $97,055?

A. That sounds pretty close.

Q. And that is the increase in tax that results from the participation of the three companies in a consolidated tax return, is that correct, sir?

A. Yes.

Q. Now, as opposed to that, we have the tax savings due to Union Producing Company losses. What was the maximum loss, tax loss on its separate net taxable income

schedules reported by Union Producing in the five years between 1956 and 1961, sir?

A. Union has never had any tax savings —

Q. Tax loss, excuse me.

A. Union has never had any tax loss. Union was able to utilize all of its tax deductions, as we show in our exhibits, during this period you are talking about.

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Q. Mr. Dunn, in your Exhibit 14-1, for the year 1957, Schedule No. 3, there is a reported separate net taxable income for United Gas Pipe Line Company per Revenue Agent's Report of $25,708,049.

A. That is correct.

Q. And I have an Exhibit L to United's 1957 calendar year tax return which shows on page 67 a reconciliation of income, United Gas Pipe Line Company, and shows at the last line net income separate return basis, $25,602,479, and the difference is only $105,000.

Am I to take it, then, that whenever there is a figure on the tax return that is called "Separate return basis, net income per return", those would be the figures from which you derive your net taxable income as shown in your Exhibit 14-1?

A. Yes. I am sure that that must be correct. I haven't seen the figure to which you refer, but the only figures

in which the Revenue Agent's Report and the return filed have substantial differences are with respect to Union Producing Company's tax return.

Q. I take it that the way in which that figure that you start off as net taxable income in each of your schedules of Exhibit 14-1 is computed is to take the separate gross income for the corporate entities involved, subtract from it the tax deductions for that entity, add to it a category known as additions to income, and offset against it a category known as reductions of income, and that that is the method by which this separately determined net taxable income figure is produced?

A. Well, those items as related to the particular company, yes, it is all the income that is required to be reported as income or revenues less the tax deductions which are authorized by law.

Q. In other words, Mr. Dunn, United follows the policy — when I say United, I mean the entire corporate complex — of filing in essence three separate tax returns, a separate tax return showing separately computed net taxable income for each of the corporate entities that participate in the return?

A. Well, I don't believe you would really describe it as filing three separate returns, separate returns are prepared and then consolidated and a consolidated return

is filed, of course, along with all the supplementary data that goes into that consolidated return.

Q. So the only thing that is filed with the Commissioner of Internal Revenue is one consolidated return?

A. Plus all the supplementary data, including the necessary data to arrive at the consolidated return which would necessarily include the separate taxable net income of each of the participating companies.

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Q. When United reports — when United Gas Pipe Line Company reports its tax paid, or tax expense for each calendar year to the Federal Power Commission annually, what is the basis on which it determines the tax expense of United Gas Pipe Line Company which participates in a consolidated return and does not file an individual return?

A. That is an accounting matter, and obviously tax returns have never been filed by United, as far as I know, when the Form 2 is reported to the Federal Power Commission,

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so that it is an estimated figure, and the accounting department obviously would be the one to answer questions as to how they report Form 2.

Q. Isn't it a fact, Mr. Dunn, that they use the allocation method described at page 506 of your testimony in

spreading the consolidated tax to the different companies participating in the consolidated tax return?

A. Well, it is my understanding that, just as I state it here, and you just read the testimony. It says although we recognize the result I have described, I am aware that some other allocation could be used for book accounting purposes, we felt it is better to allocate the consolidated tax in accordance with the rules prescribed by the tax law in the computation of earnings and profits of the respective companies which are included in the consolidated return.

Now, that does say that that particular procedure was used for book purposes, for book accounting purposes. Now, of course, the amounts are different from what appear on the tax return, because the tax return has not been filed when the books are closed.

Q. Then would it not be a correct statement that the tax expense for United Gas Pipe Line Company as booked in accordance with the FPC system of accounts, and as reported annually to the Commission, is predicated upon an allocation of consolidated tax to the different tax filing —tax

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reporting entities included in the consolidated return in accordance with the method described at page 506 of your testimony?

A. Yes.

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Q. How does United Gas Pipe Line Company determine the amount of tax which it shall pay to United Gas Corporation at the end of each year for the UGPL tax liability portion of the total consolidated return tax liability?

A. That is an accounting — that is a matter handled through the accounting department. To get the correct answer, you just ask — Mr. Luke was here and could have given you the answer.

Q. You are the tax witness, and Mr. Luke conscientiously refrained from tax questions.

PRESIDING EXAMINER: Let's not argue about it.

Do you know how this was done? I believe the testimony was that there is a common accounting department.

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THE WITNESS: Yes, and, of course, it is a simple matter to transfer the necessary funds to meet these tax liabilities. Now, my understanding of it is — I didn't go into it particularly, it is not important to me, and has nothing to do with this rate case — if memory serves me right, the cash is simply transferred in accordance with the allocation that I described on page 506 of the transcript. That is done for accounting purposes as well as tax purposes, and as explained that is a reasonable method of disposing of this inter-company problem.

MR. BERKELEY: If I understand the answer, Mr. Examiner, the witness has now answered the question.

PRESIDING EXAMINER: Then let's proceed.

BY MR. BERKELEY:

Q. If you discover that you are incorrect in your answer by consultation with Mr. Meece or others who might know, will you please let us know?

A. I will.

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MR. FLETCHER: I can correct it for you now, Mr. Berkeley. He is in error.

Each company writes its own check for its own share of the tax and pays it to the Director of Internal Revenue.

Don't shake your head at me — that is the fact.

MR. BERKELEY: We apparently had a misunderstanding. I don't care who pays the tax. My question is how does United Gas Pipe Line Company decide how much money it shall pay for its share of the tax, and I don't care whether it writes the check to the Commissioner of Internal Revenue or to United Gas Corporation.

MR. FLETCHER: That was your question.

PRESIDING EXAMINER: All right, the witness' answer is on record here. Let's proceed,

BY MR. BERKELEY:

Q. Now, if I understand your exhibits and direct and rebuttal testimony correctly, it reduces to a basic and simple proposition that the tax allowance made by the Federal Power Commission in a pipeline rate case for a company which participates in a consolidated tax return should not reflect any savings, if savings did exist as a result of the filing of a consolidated return — is that correct, sir?

A. I deny that there is any savings from any other company, because I know there has not been, but your question was an "if" question.

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Even if Union did have some tax savings from its oil operations, I do not know why they belong to any customer buying gas from United.

The fact is that all of Union's oil losses can be used up by its oil operations, so there is nothing available from the oil operations to give away to United Gas Pipe Line's customers. They are not entitled to it, there is nothing to give, and it is just an absolute confiscation of property the way the staff has attempted to give those oil losses to customers of United Gas Pipe Line Company.

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Q. In your opinion as an expert witness appearing for United, Mr. Dunn, would it be a fair procedure for the Commission to determine the taxable net income of United Gas Pipe Line Company on the assumption that it is a separate company filing a separate tax return?

A. You don't have to make any assumptions in determining fair income for utility operations. You take the facts and relate them to the property that is in the rate base. You don't go around just taking a company and disregard the fact that its operations may or may not be subject to regulation.

Q. And the facts are, as you see them, that United Gas Pipe Line Company is separately operated, and therefore should not have the benefit of any Union Producing Com-

pany tax deductions which result in tax losses, for the benefit of any United Gas Corporation tax deductions which result in tax losses, correct?

A. I don't know what you mean by benefit of tax losses. Union can use its own tax losses, and the customers haven't any claim on any oil tax deductions in any way, shape or form under the guise of so-called tax losses, or for any other reason. Those tax losses belong to Union, and the only tax

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deductions that need to be considered in a rate case are those tax deductions that arise from the investment and expenses that are included in the cost of service.

Q. Perhaps we can get at it in a simpler manner. This is a fairly non-controversial subject.

You state that Union is entitled to its own tax losses, and United Gas Corporation is entitled to its own tax losses, and of course United Gas Pipe Line Company should be entitled to its own tax losses?

A. They don't have tax losses. I can't answer that question. These companies haven't had tax losses. United Pipe Line doesn't have tax losses in any year.

Q. United Gas Pipe Line Company never has tax losses because as soon as it is threatened with loss of income it files promptly for a rate increase, is that correct, sir?

MR. FLETCHER: Oh, Mr. Examiner—

MR. BERKELEY: It has a legal right—

PRESIDING EXAMINER: Please, Mr. Berkeley, you are not on the stand. Let's proceed.

BY MR. BERKELEY:

Q. Isn't it correct that the only way in which a company can legally keep separate the tax loss in a given year that belongs to any of the companies that participate in a consolidated tax return is not to file a consolidated tax return, Mr. Dunn?

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MR. FLETCHER: Now he has called for a question of law. I object. If he asks a question of mechanics, let him answer. He says isn't it true the only way they can legally do it—

MR. SPIEGEL: I object to the objection on the grounds that this witness has put in legal testimony. I objected to it, the Examiner refused to strike it, and it seems to me you have got to allow some leeway to counsel to ask some legal questions. Either that, or you have said that our cross examination should be in the brief, and I think this kind of direct testimony should be in the brief.

PRESIDING EXAMINER: Please, counsel, let's proceed with the examination.

MR. FLETCHER: I sure would like to answer that.

MR. BERKELEY: I have a question pending.

PRESIDING EXAMINER: All right, would you read the pending question?

(The question was read.)

PRESIDING EXAMINER: All right, we will strike the word "legally", and you may answer the question.

THE WITNESS: Well, the question is pretty garbled.

MR. BERKELEY: will make it more specific.

BY MR. BERKELEY:

Q. Union Producing Company in several years has had negative tax income — in other words, an excess of tax deductions over tax income, correct, sir?

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A. Yes.

Q. In these years, there was a consolidated tax return filed in which the total aggregate separate net taxable income of United Gas Corporation and United Gas Pipe Line Company was reduced by the fact that Union Producing Company had a net tax loss in that year, isn't that correct, sir?

A. Well, you talk about being reduced. It is because in a consolidated return you reflect all revenues and all tax deductions. You only owe so much tax.

Now, what has been reduced? You have one tax figure. There is nothing reduced by that tax figure. It is a tax figure that reflects only the elements of revenues less expenses. That produces a tax figure.

Some of those expenses came from Union, some of those expenses came from United Gas Pipe and some from United Gas Corporation. The same way with revenues. Now, there is no co-mingling or loss of identity of any item. Each item to be supported in a tax return must be described, the nature of it disclosed, supported by expenditures, all the detail

required by the Bureau, so that there is no loss of identity of any tax deduction or any item of revenue in a consolidated return.

Q. And isn't it a fact, also, Mr. Dunn, that when Union Producing Company, or any other member of a tax filing group has deductions which exceed its taxable income for a given year that the benefit of these loss deductions by carry-back or

carry-forward can only be against the aggregate consolidated tax income of all members of the group in earlier years or later years?

A. There is no need to have a carry-forward or carry-back unless you need it. That is the purpose of having a consolidated return. That is why the law allows a consolidated return so that you can reflect currently all of your deductions.

Now, if you have more deductions than you can use, the law goes farther and permits you to carry those deductions back three years, and if you can't carry them back three years you may carry them forward five years.

Q. But isn't it true that this carry-back and carry-forward takes place only on a consolidated basis?

A. If the consolidated basis is sufficient — I don't understand the word "only". However, in order to avoid any confusion about this problem, I have made a study of the separate returns to see whether Union, itself, on a separate basis was able to use all of its tax deductions, and that study proves conclusively that whether a consolidated re-

turn basis is used or a separate return basis is used, Union, itself, can use all of its tax deductions. Therefore there is no tax loss that is ever of any use to the other two companies.

PRESIDING EXAMINER: But, Mr. Dunn, I don't think you are answering this particular question.

If the aggregate files a consolidated return this year,

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and if next year it wants to carry forward or carry back, it cannot do that on an individual return basis, can it?

THE WITNESS: I wouldn't assume so.

PRESIDING EXAMINER: It has to be filed on a consolidated basis.

THE WITNESS: I am sure Mr. Gilpin can answer that question. He is a tax attorney.

MR. SPIEGEL: Is your answer that you don't know?

THE WITNESS: I wouldn't be positive about it. We never have to do that, because I don't recall, except for very minor items that are ever carried forward or carried back. There are some special tax treatments with regard to things such as contributions, charitable contributions —

BY MR. BERKELEY:

Q. Mr. Dunn, that is beside the point. I have a very simple question. I am trying to find out what United Gas Pipe Line and United Gas Corporation have actually done in the years from 1956 to 1961.

Isn't it a fact in those years that on its tax return, when there has been an aggregate of tax deductions over tax income for Union Producing Company, they have used that

tax loss in the year in which it occurs to wipe out or eliminate or offset taxable income of United Gas Corporation and United Gas Pipe Line Company — isn't that correct, sir?

A. Well, now you are on a separate versus a consolidated

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basis. As you just pointed out, there is only one taxable income when the tax return itself is filed, and that is composed of revenues and tax deductions from all three sources. They are all used, and the figure is a consolidated taxable net income, and that is used currently.

Now, you were talking about carry-forwards and carry-back within this five year period, and I say that only very minor amounts due to charitable contributions had special tax treatment with respect to them.

Q. But even if there had been some, or to the extent there were some, they were still dealt with on a consolidated basis, were they not?

A. That is my understanding, but we haven't had it, and as to all the ramifications of the tax law on that Mr. Gilpin can tell you.

Q. As I understand the purport of your testimony, however, you are saying this. You are saying it is just not equitable, irrespective of the law, that a tax loss generated by the operations of Union Producing Company should be used to reduce the tax payable by the ratepayers of United Gas Pipe Line Company, because they are two separate unrelated operations, is that correct?

A. No, that really isn't my testimony. My testimony is that when Union, itself, can use its tax losses and when

Union, itself, is partially subject to regulation that whatever tax

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deductions Union has should be considered in Union's rate case, and have been considered in Union's rate case in the test year '58, and I came along and found the staff of the Commission trying to use them again in United Gas Pipe Line's rate case — in other words, use them twice.

Furthermore, they went to oil operations, and they tried to use oil operations to give to Union's customers, and then they went to the oil operations again and tried to give them to United Pipe Line's customers.

Now, with respect to the use of Union's tax deductions, the Commission certainly under the law, under regulation, can consider those tax deductions and those statutore tax deductions for percentage depletion that related to gas, but whether the Commission can take oil percentage depletion and oil well drilling costs and tax deductions related to oil and give them to the gas customers is something that would have to be approved by the courts. I don't think any company would consent to that.

Q. Well, you have so many considerations in your answer, Mr. Dunn, I am puzzled where to begin, but I want to pin one simple concept down.

If I understand your testimony correctly, and I am trying to get the bare essentials and leave out the petty details, your basic philosophy about this is that if Union can get the tax benefit of the savings itself they shouldn't be used for anybody else's purpose. In other words, if we had a situation where

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Union never had any tax income, you would then agree that

it could be used by United Gas Pipe Line and by United Gas Corporation?

A. Well, I don't understand what you mean by never had any tax income. The Commission will have to fix rates for Union, since it is subject to regulation, and it will use Union's tax deductions to fix Union's rates.

Now, I object to your assumption that Union's tax deductions can be used again to reduce United's rates. If they are used to fix Union's rates, they are not available to use to fix United's rates, and as far as oil tax deductions, they are not available to any gas customers.

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Q. Isn't it also a fact that several exhibits prepared by Mr. Meece initially and sponsored by you refer to 1962 budget in this case, and 1962 estimated tax for nine months of the year?

PRESIDING EXAMINER: Well, can we have a reference to a specific exhibit?

MR. BERKELEY: Exhibit 14-6, Mr. Examiner, as prepared by Mr. Dunn is designed to show the tax effect of the 1962 rate refund. Before Mr. Dunn could prepare this exhibit, he knew that the refund was 35 million. He knew that at a 52 percent tax rate that is worth about 18 million dollars. He had to know what the total aggregate consolidated gross income —

PRESIDING EXAMINER: Why don't you ask him what that figure is? I assume it is in the record somewhere.

2879

MR. BERKELEY: I have asked him, and he says he didn't know it at the time he prepared the exhibit.

PRESIDING EXAMINER: All right, do you know?

MR. FLETCHER: Mr. Examiner, if you will indulge me, Exhibit 14-6 on its face is an estimate for 1962 only as to United Gas Pipe Line Company.

Now, I am trying to get the exhibit number right now, which I think is 2-45 — have you got that, Mr. Dunn?

THE WITNESS: Yes.

MR. FLETCHER: That is in the filing, and that does have an estimate, but it is an estimate, and I call the attention of the witness to Exhibit 2-45.

MR. BERKELEY: Mr. Examiner, it is right in Mr. Dunn's Exhibit 14-6. He has a column, and at the end of it the first note says 1962 estimated tax liability of United Gas Pipe Line Company on consolidated return basis before giving effect to the rate refund deduction, and that figure is shown as $7,640,000. That is physically impossible to allocate part of a total consolidated tax —

PRESIDING EXAMINER: Let's stop arguing about this, and get the figure on the consolidated return estimate. We are just going around in circles.

MR. BERKELEY: I will ask it again.

BY MR. BERKELEY:

Q. Mr. Dunn, turn to your Exhibit 14-6, please, the

first note following the table refers to a 1962 estimated tax liability of UGPL on a consolidated return basis before giving effect to the rate refund deduction.

Before you could arrive at that figure, which obviously represents an allocation of estimated consolidated tax for 1962, you must have arrived at an estimated consolidated tax for the entire system for 1962. Please give us that figure.

PRESIDING EXAMINER: All right, we will take our recess at this time, and when we come back, let's hope we can proceed.

(Whereupon, at 3:30 p.m., the hearing was recessed until 3:42 p.m.)

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PRESIDING EXAMINER: May we come to order, please?

Do you have the answer, Mr. Dunn?

THE WITNESS: I checked on one answer Mr. Berkeley asked concerning the billing between companies for the consolidated tax.

When the taxes are accrued, they are distributed in accordance with this method which I have described as being a method used for tax purposes, and each company then sends its own check to the Bureau of Internal Revenue, so there is no inter-company billing.

Now, in the event that later on the taxes are underpaid, that underpayment is allocated in the same way, and a check is sent to the Bureau of Internal Revenue.

Now, if in some later period there is a refund, that refund is taken to the year in which it applies. The taxes for that year are recomputed, and the refund is also applied to the companies on the basis of the reallocated tax.

(2881)

BY MR. BERKELEY:

Q. Then do I understand your testimony correctly that the various rate refunds shown as a reduction of United Gas Pipe Line Company's separately computed net taxable income in the second line of your Schedule 3 to 7, inclusive, of Exhibit 14-1, represents sums of money which United Gas Pipe Line — which United Gas Corporation

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and its subsidiaries will pay back to United Gas Pipe Line Company?

A. Well, actually it will be the Treasury Department that pays it back, because the money was paid to the Treasury Department, and actually that figure shows much clearer again on 14-6.

The first part of it, that Schedule 14-6, shows that United Gas Pipe Line Company, if its tax had been assigned to it at the full 52 per cent rate instead of this allocated basis, would have gotten back $15,364,328, but taking the refund and reworking it to the year shown, namely reworking it for '62 in its entirety, and for the year '59, they only get back $13,443,083.

Now, that is because it was not charged with the full 52 per cent tax due to the allocation, and therefore the refund is something less than a full 52 per cent tax, the refund being computed exactly as the original tax was computed.

Q. And the tax saving or reduction in taxes due to the refund will be on the order of 18 million, will it not, or 52 per cent of the 38 million dollar figure, so that the difference between roughly 18 million and $13,443,000 will be

retained by other members of the tax filing group, such as United Gas Corporation and Union Producing, is that correct, sir?

A. Oh, no, the tax overpayment at 52 percent was

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$15,364,328, but the overpayment on the basis of the allocated tax of United Gas Pipe Line was $13,443,083. That is simply the consolidated effective tax rate as computed by means of an allocation procedure working in reverse. It is charged too little tax, you get back something less than the full 52 per cent of the tax.

Q. What is the percentage, Mr. Dunn? You said the tax saving wouldn't be computed at 52 per cent, but would be computed at the percentage that had actually been charged in the allocation of consolidated tax to United Gas Pipe Line Company.

What will that percentage be, sir?

A. Well, for the year 1959, it would be the percentage — whatever it works out to be. It is worked out on a dollar basis, not a percentage basis. We allocate total tax on the basis of taxable net income, and those are dollars. In the year '59, the total amount of tax liability after giving effect to the loss carryback deductions for 1962 is the figure of $4,177,782. Now, that represents an allocation of 87.692 per cent of the total tax to pipeline company, 12.308 per cent to corporation, and nothing to Union for that year.

Q. We are getting ahead of ourselves, Mr. Dunn.

I was after a simple question. I was after how much cash will United Gas Corporation and its subsidiaries as a

single unit receive from the Federal Government by virtue of the carryback? Have you a figure based on your computations as to that sum of money?

A. $15,364,328, that is the total effect of that — no, I beg your pardon. That may not be. That is the total effect to United Gas Pipe Line Company. There are other effects on the Gas Corporation, because some of that refund went to Gas Corporation.

Q. Do you have with you, Mr. Dunn, so we can simplify the matter, the total dollar amount of the refund of principal and the payment of interest — refund of principal and interest made by United Gas Corporation pursuant to order of the Federal Power Commission on March 16, 1962, made by United Gas Pipe Line on March 16, 1962?

Would it be a total of $35,454,262 as booked by United?

A. I was just seeing if I had it on one of these working papers.

Q. Would you like to look at the sheet Mr. Meece gave me which summarizes it?

A. Well, that is shown on this sheet.

Q. Well, I wish to know if that is correct, sir, not whether it is shown on the sheet.

A. Well, that is what I was saying — I was looking in my working papers for the exact amount. Yes, that is shown in the working papers, $35,454,262.

Q. And is it correct that $29,778,219 of that sum is a refund of principal, and that $5,676,043 of that sum represents interest?

A. That is correct.

Q. All right, sir.

Now, it is obvious that on any theory, the reduction in the total taxes paid by the single consolidated tax return group will be 52 per cent of $35,454,262, is it not?

A. Not necessarily. Some of that refund may go to United Gas Corporation.

Q. My question was directed to the tax saving resulting from the — the tax saving to the consolidated return entity, which comprises United Gas Corporation, United Gas Pipe Line Company, and Union Producing Company, and Union Overseas Producing Company.

Now, with respect to all of them considered as a single tax filing entity, which they are, won't the reduction in taxes due to the making of this refund by United Gas Pipe Line Company amount to $18,436,216?

A. Well, that may be in the working papers. I hadn't computed it for all of them. I computed it only for United Gas Pipe Line Company.

Q. Doesn't it necessarily follow by simple logic that if you have a tax deduction in the amount of $35,454,262, and the corporate tax rate is 52 per cent, that

the availability of this tax deduction to the consolidated tax return group will save it $18,436,216?

A. Not if some of the refunds go to another member of the group.

Q. I am speaking of the entire group in the aggregate. I am not concerned with how they divide the pie.

A. You are off on a different wave length. I was only talking about the refund the Commission ordered on United Gas Pipe Line, some of which goes to United Gas Corporation.

Q. What portion goes to United Gas Corporation in its capacity as a customer — do you have that, sir?

A. Well, I can't tell you offhand. It can be computed.

Q. Isn't it completely immaterial whether it goes to United Gas Corporation or anybody else, because the tax — because the refund of principal and interest is made by United Gas Pipe Line, and it is its action in making the refund of principal and interest which generates the tax deduction?

A. The item is completely immaterial in this rate case, because it refers to years that are not even involved in this rate case, but it is certainly material in filing your tax return as to whether it is ultimately taken out of the consolidated return or does stay in the consolidated return.

Q. Well, I had a question pending which wasn't answered. May I have the question read back, please?

PRESIDING EXAMINER: Mr. Dunn?

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THE WITNESS: He asked me if it is immaterial. It is immaterial to this rate case, but I said it was material to the tax return whether or not the money went completely outside the group or whether some of it was retained within the group.

PRESIDING EXAMINER: Well, it seems to me that you keep getting off on collateral and peripheral matters. As I understand the questioning, it is simply directed to the effect of the refund on the tax filing aggregate, without reference to how the money is distributed.

THE WITNESS: How the money is distributed is material.

BY MR. BERKELEY:

Q. It this what you are referring to, Mr. Dunn, that to the extent that the refund was to United Gas Corporation, the corporate entity as a whole will have to eliminate that portion of the refund on the consolidated tax return?

A. Not necessarily all of it. The corporation may have obligations to in turn refund some of the money. They may have no obligation to refund any of the money.

Q. All right, sir, would you please tell me, or supply for the record if you don't now have available the figure, what portion of the total refund of $35,454,262 will be retained by United Gas Corporation and will not result in an eligible tax deduction on the consolidated tax return for 1962?

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You must have this figure, because you used it in preparing Exhibit 14-6, did you not?

A. No, I wouldn't need that.

Q. Well, sir, how would you possibly know what the tax effect of a rate refund in 1962 was if you didn't compute the tax deduction that would be available to the consolidated tax filing entity in 1962?

A. Well, the way we computed it here is to first estimate the total tax liability for 1962 without considering the 1962 FPC rate refund.

Q. All right, sir, what was that figure, please? I have asked for that figure three times, and you have had an opportunity during the recess.

A. The figure is $7,647,645.

Q. That is the figure for United Gas Pipe Line, is it not?

A. That is the total figure, also.

Q. Let me ask this question, Mr. Dunn. In preparing Exhibit 14-6, did you attempt to determine what the total consolidated taxable income for the entire tax filing group would be, exclusive of the rate refund deduction attributable to the Commission's March 16, 1962 order?

A. That is the figure I just gave you, yes.

PRESIDING EXAMINER: Pardon me, that is the figure for the aggregate for the consolidated tax return?

THE WITNESS: Yes, sir.

PRESIDING EXAMINER: Not merely for United Gas Pipe Line?

THE WITNESS: Well, you see, it all goes to United Gas Pipe Line, because in 1961 Union had a small loss, and also Corporation had a small loss or estimated loss for 1962, so therefore the only company that had income was Pipe Line, so in accordance with this allocation of allocating — this basis of allocation, we allocated only to the company that had taxable net income, which meant that Pipe Line got all the tax in the year 1962, or the estimated tax in the year 1962.

BY MR. BERKELEY:

Q. Mr. Dunn, you keep speaking of allocations, and I am asking only one simple fact.

Did you or did you not in preparing Exhibit 14-6 make an estimate of the total consolidated taxable income and the total consolidated tax which would be payable in 1962 for the entire tax return group without regard to the rate refund deduction attributable to the 35 million dollar refunds made by United Gas Pipe Line?

A. I just answered that at least twice, that we had, and that the total figure was $7,647,645.

Q. Then the total aggregate consolidated tax for United Gas Pipe Line Company, Union Producing Company, United Gas Corporation, and Union Overseas Producing Company was a

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tax of $7,647,000, exclusive of the refund, is that correct, sir?

A. That is the estimate.

Q. And if we took a number and multiplied it by 52 per cent, any number, or the number which when multiplied by

52 per cent yields $7,647,000 would be the consolidated tax income for 1962 as estimated by you, correct, sir?

A. Well, I have the figure here.

Q. Please supply it.

A. The revised taxable income, including dividends, was $14,676,265. That is made up of a consolidated breakdown of the three companies, United Gas Pipe Line Company, $14,117,146, Union Producing Company, $1,074,330, United Gas Corporation a red figure or net loss after eliminating dividends of $515,211.

MR. BERKELEY: Mr. Examiner, may we have those figures read back, please?

PRESIDING EXAMINER: Yes.

(The answer was read.)

THE WITNESS: If I might go ahead, the aggregate of those figures is $14,676,265.

Then on Union there is a two percent additional allocation tax of $21,487, then there is a $5500 surtax credit, leaving the total tax of $7,647,645. That was allocated 92.92 per cent to United Gas Pipe Line in the amount of

$7,106,804, and 7.072 per cent to Union Producing Company in the amount of $540,841. Then following the procedure that since Pipe Line Company gets Union's losses it pays Union's taxes, the $540,000 was assigned back to United Gas Pipe Line Company, bringing the total to United Gas Pipe Line Company to $7,647,645.

Q. All right, sir, what about United Overseas during this period?

A. Nothing was estimated for them one way or the other in this estimate.

Q. Did you make any inquiry as to whether they would be profitable or unprofitable during the year?

A. Nobody knows.

Q. Well, in 1961 you reflect their operations which I believe were unprofitable, isn't that correct?

A. That is right, it is an exploration company, and they may well have a loss, but nobody knows how these are going to turn out.

Q. Last year is it not correct was the first year, 1961 was the first year in which they commenced operations of Union Overseas?

A. Well, it will show in my actual figures for the year's tax returns. As I recall, that was the first year, at least the first year that it appeared in the tax returns.

Q. Isn't it likely that their results would be more

profitable or less unprofitable in the second year than in the earlier year — in the second and third years when they begin drilling and may have some luck in finding profitable wells?

MR. FLETCHER: Mr. Examiner —

PRESIDING EXAMINER: I am going to sustain the objection.

BY MR. BERKELEY:

Q. Did you make no inquiry at all as to the potential tax liability or tax income of United Overseas, Mr. Dunn?

A. I personally didn't. Mr. Barham may have. He collaborated on working on this.

MR. BERKELEY: That is hearsay. I move it be stricken.

PRESIDING EXAMINER: If you ask the question, you are stuck with the answer. Let's proceed.

MR. BERKELEY: Mr. Examiner, I think this computation Mr. Dunn has goes to a very vital element of this case, and I think it would be most helpful in explaining and understanding and evaluating his Exhibit 14-6 that we have that worksheet that he has been reading from. Otherwise, we will have great difficulty in digging it out on cross examination, whereas if it is available, everybody can quote it in the brief and we won't have any difficulty, sir.

PRESIDING EXAMINER: Do you have any objection, Mr. Fletcher?

MR. FLETCHER: If he wants to offer it, I don't.

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MR. BERKELEY: Well, it is part of a worksheet.

MF. FLETCHER: You can offer it if you want to.

PRESIDING EXAMINER: Nobody is objecting.

MR. BERKELEY: I would like to offer it in evidence, Mr. Examiner Can it be marked for identification and can Mr Dunn supply us a copy so we can have it reproduced?

MR. FLETCHER: He will lend you his copy, and then you can return it to him — when he gets through testifying.

BY MR. BERKELEY:

Q. Mr. Dunn, you speak of that year as a year in which 92.98 per cent of the total consolidated tax income and tax liability were allocated to United Gas Pipe Line Company.

How do you account for that high percentage of an allocation to United Gas Pipe Line Company which in that year made refunds that wiped out all tax liability for all the constituent members of the tax return group and also resulted in a substantial carry-back to the year 1959? Don't you think that you should have reflected the rate refund in allocating tax to United Gas Pipe Line Company?

MR. FLETCHER: Now, counsel himself brought out a minute ago by his own questions that that figure was before refunds. I don't see any profit in the question.

MR. BERKELEY: I don't understand how —

PRESIDING EXAMINER: You may answer the last part of the question, the question part. Would you read that, please?

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(The question was read.)

THE WITNESS: In the first place, the refund didn't wipe out any tax liability. We paid our tax liability for the year or will pay it for the year 1962, with the fact that we paid too much money in prior years, and as shown on 14-6, the tax liability is $6,647,645.

Now, since that will be paid by foregoing a refund, and, in addition, we will have a carry-back to 1959, the net effect

is that we will get back the 13 — United Gas Pipe Line will get back the $13,443,083 that it was overcharged in years prior to 1962.

MR. BERKELEY: May I have that answer read back, Mr. Examiner? It was very difficult to follow.

PRESIDING EXAMINER: All right

(The answer was read.)

BY MR. BEKEELEY:

Q. You referred in your answer to a figure of tax liability of $6,645,000 in Exhibit 14-6. I can't find it there. Will you please refer me to the line and column?

A. I think the only figure I referred to was the 1962 estimated tax liability of $7,647,645. That liability is not wiped out, it is simply paid by foregoing a refund.

Q. But isn't it a fact that in the earlier years in which the tax was paid, the Internal Revenue people are not giving you any refund of tax paid in that year, are they?

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A. Would you read the question, please?

(The question was read.)

THE WITNESS: They are giving a refund of the 1959 overpayment, yes.

BY MR. BERKELEY:

Q. Only 1959, because of the carry-back of the loss from 1962, isn't that correct, Mr. Dunn?

A. Well; if you can carry it all back to 1959, that is where you carry it back to, three years back.

Q. But you use it first in the year in which the tax loss is realized, which is 1962, isn't that correct?

A. Well, you use it to pay the 1962 tax. There isn't any particular point in sending them a check for seven million-odd dollars and then having them send you the check back again.

Q. And it is also a fact that you won't receive any interest from the Bureau of Internal Revenue for the alleged overpayment that you say was made for taxes in 1956, '57, '58, '59, '60 and '61?

A. No, no interest.

Q. And then isn't it a fact that at least under the tax law, the transaction represents a reduction in taxes in the year 1962 for the first time?

A. There is no reduction in taxes in the year '62.

Q. It is a tax deduction which under the tax law becomes available for the first time in 1962.

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MR. FLETCHER: Oh, let's not argue that point again, Mr. Examiner.

PRESIDING EXAMINER: I will sustain the objection. It is strictly argumentative at this point.

BY MR. BERKELEY:

Q. You spoke in your answer also of the fact that the refund didn't wipe out any part of the tax liability that would otherwise be payable of $7,647,000 for the entire consolidated tax return group.

Isn't it true that the consolidated tax will be zero in 1962?

A. No, sir.

Q. Will United Gas Corporation and its subsidiaries viewed as a single consolidated tax return entity pay any tax in 1962, Mr. Dunn?

A. Certainly, they will pay it by foregoing a refund. If you owed me $50 and I owe you $50, I can pay you and you can pay me by us foregoing what we owe each other.

Q. Is it your understanding of the tax law, Mr. Dunn, that United Gas Corporation would have an option as to the tax treatment of this $35,454,000 item and take it as a refund in the earlier beginning '56 and ending '61?

A. Have an option to do what?

Q. Could United Gas Corporation forego a tax deduction in the amount of $35,454,000 in 1962 —

A. That is not a tax deduction. I can't answer that question. It is not a tax deduction. It is a refund, that is an overpayment of taxes — not a deduction.

Q. Isn't it claimed under Section 1341 of the Internal Revenue Code?

A. As I understand it, 1341 is the right to go back to the respective years. I don't think they are going to take this under 1341.

Q. What section will they take it under?

A. I would have to find that out from Mr. Barham.

Q. Would you supply that information?

A. Yes.

Q. Are you aware of any option the company may have under eht tax laws to reform its tax returns for earlier years with respect to these refunds?

A. All procedures under the tax laws involved certain risks, from penalties as well as options. As I understand it, there is a 1341 procedure prescribed, which if it does not serve any useful purpose there is no use going to that procedure.

Q. There was no tax benefit?

A. Oh, no.

Q. Are you prepared to state there is no benefit —

A. You have attempted to distort my testimony. I say if there is no difference in the result you get, there is no

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use going to that form.

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THE WITNESS: The tax return, the consolidated tax return

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will reflect elimination of intercompany dividends to the extent that they have been included in the return — in other words, the return will be prepared in such a way that there will be no tax on intercompany dividends.

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BY MR. BERKELEY:

Q. Is that also true of intercompany interest payments made by the pipeline to the Gas Corporation?

A. That is right, and, of course, the revenues from those intercompany interest payments will also be eliminated to the extent that there is no tax on revenues from intercompany interest, or payments of intercompany interest — it is washed out.

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Cross-Examination by Memphis Light, Gas and Water Division —

BY MR. SPIEGEL:

Q. I would like to refer you, Mr. Dunn, to transcript page 518 in which you state that the taxable income shown for certain years in Smith's Exhibit No. 23 do not in all cases reflect all the revenue agent report adjustments and Internal Revenue Service adjustments.

I would like you to turn to Exhibit 23, Schedule 6, and tell me what figures should be adjusted in the light of your statement.

A. To the extent that the figures for taxable income and consolidated tax in Exhibit 23 do not agree with the taxable net income per revenue agent's report shown in Exhibit 14-1, Schedule No. 3 and following schedules for the respective years, they do not reflect the adjustments made by the Internal Revenue Service.

Q. Well, I am trying to relate the figures which we have used — which were obtained from the company — to what may be revisions of tax returns or RAR reports subsequent to the time the figures were furnished us.

Now, in Exhibit 14-1, the comparable figure is not shown as such. In other words, you don't show in Exhibit 14-1 the net taxable income in consolidation for United Gas Pipe Line, as such. I believe that to be the case, sir.

A. That is correct. The taxable net income for the three

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separate companies is shown, and the consolidating adjustments are shown, but the total is not shown, nor do I have it readily available.

MR. SPIEGEL: Mr. Examiner, I would like to have marked for identification as an exhibit a one-page document entitled "United Gas Pipe Line Company, Docket No. RP63-1, Summary of Taxable Income in Consolidation, Years 1957 to 1961", about which I would ask some questions of this witness.

PRESIDING EXAMINER: All right, do you have copies there?

MR. SPIEGEL: I have copies.

PRESIDING EXAMINER: All right, the document just described will be marked Memphis Exhibit No. 36 for identification.

(THE DOCUMENT REFERRED TO WAS MARKED FOR IDENTIFICATION AS EXHIBIT NO. 36.)

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MR. SPIEGEL: The pending question is whether Mr. Dunn is in a position to accept these figures as being the taxable income as it applies to Exhibit No. 23, Schedule

No. 6, of United Gas Pipe Line, the ones to be substituted in his view for those shown on Schedule 6 of Exhibit 23.

THE WITNESS: Of course it is utterly impossible for me to check as to a figure which I don't have, except in this way.

It appears to me that what this schedule shows is that it was taken from Exhibit 14-1, from the respective schedules, and simply reverses certain adjustments that appear on those schedules under the column "Adjustments" on line 3 for the respective periods, to come to a consolidated total. Is that what you did?

BY MR. SPIEGEL:

Q. Yes, basically—

PRESIDING EXAMINER: Well, let's accept the figures subject to check as purporting to be what they are, subject to check, and I take it they are derived entirely from Mr. Dunn's exhibits.

MR. SPIEGEL: In an effort to speed up the cross examination, I was responding to Mr. Dunn that these figures are derived by eliminating the inter-corporate trans-

actions which are eliminated in developing a consolidated net taxable income, but they do not include your further adjustments which you described in your testimony for out-of-period and non-utility costs, and the like, as you express it.

THE WITNESS: In other words, these figures would put back into the taxable income Union Producing Com-

pany's oil tax deductions, and they would put back into the income for the respective years the amount of rate refunds that the Commission —

PRESIDING EXAMINER: Well, they put in Union's oil losses, as I see by these negative figures, is that correct? Is that what these negative figures are?

MR. SPIEGEL: Yes.

MR. FLETCHER: My only observation is, Mr. Examiner, with your suggestion that we accept it subject to check, I can accept the figure, but not as representative of the taxable income.

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MR. SPIEGEL: But when you go to his Exhibit 14-1, he does not show, as such — and he so testified — the taxable income in consolidation in its most final revised form as approved by Internal Revenue.

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MR. SPIEGEL: Well, I am trying to find out from Mr. Dunn — the figures that we have in Mr. Smith's exhibit, Schedule 6, were provided to us by the company. I am now trying to find out from Mr. Dunn whether these are the appropriate figures to be substituted for Mr. Smith's appropriate figures, or whether something else should be

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substituted for it.

Now, I can go through figure by figure, if necessary.

PRESIDING EXAMINER: Can't we agree as to the accuracies of this summmary subject to check?

MR. FLETCHER: Mr. Examiner, I am willing to do what you first suggested — I am willing to agree for the purposes of the cross that this is a computation which can be checked, and he will accept the figures of the computation subject to check, but I wouldn't attempt to agree that there is any substantive merit or affirmative correctness in these figures, I don't know.

PRESIDING EXAMINER: Let's proceed on that basis, Mr. Spiegel, that will enable you to proceed with your cross examination.

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Q. Mr. Dunn, at transcript 2946, your counsel stipulated —

A. Do I need the transcript?

Q. I don't think so At transcript 2946, your counsel, Mr Fletcher, stipulated that Exhibit 14-6, column 2, contains the latest adjusted Federal income tax figures, and my question is can you give me the related Federal income tax figures for each of those years 1956 through '61 of the consolidated tax and of the tax as allocated to United Gas Corporation and Union Producing?

In other words, I would like to have the latest figures which are consistent with the figures that are in 14-6, column 2.

A. Now, you would like to have the figure for 1956 comparable to the $11,710,802 that was allocated to Gas Corporation and to Union Producing Company for that year?

Q. Yes, along with the total consolidated tax.

A. All right, this may already be in the record — maybe it is just the percentages I read in.

Q. I think the percentages are. We checked very carefully.

A. For the year '56, the total consolidated tax is $12,800,090. Allocated to United Gas Corporation, $1,089,288, and nothing to Union. In other words, if you add that figure I just gave you and the 11 million, you

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would come to the $12,800,000 figure, so I will read them in that fashion.

Q. You might as well read in United Gas Pipe Line at the same time so I will have the whole thing.

MR. FLETCHER: That is already in the record — I object to that.

BY MR. SPIEGEL:

Q. All right, don't bother.

A. Consolidated tax, this is 1957, $13,560,947. United Gas Corporation, $1,311,344. Nothing to Union.

For 1958 — that requires a little addition and subtraction in that year, because Union had a profit.

The total consolidated tax, $16,188,431. United Gas Corporation, $1,845,481 — no, change that. It is $2,188,676. Those two figures added together give the total.

BY MR. SPIEGEL:

Q. What is it for Union Producing?

A. Nothing, they had a tax, but that tax was reallocated which is why I had to do some mental adding.

For 1959, total consolidated tax, $11,373,269, United Gas Corporation, $1,400,049, and nothing for Union.

For 1960, the total consolidated tax, $8,265,382, United Gas Corporation $1,101,362, and nothing for Union.

For 1961, total, $7,998,911, nothing for Corporation or Union.

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Of course, in addition to that, if Union even thought that they were faced with a tax loss that was to be given away to some customers of United Gas Pipe Line Company on the grounds that Union couldn't use it, Union can easily and very readily sell a production payment, produce income and use its tax loss.

Furthermore, of course, Union being a producing company, its tax deductions are controllable. Union can control how many wells it drills in any year, and one of the main items of tax deduction is well drilling expense, both producing wells and non-producing wells, and in any given period of time Union can control to a very large extent how many wells it drills, so that there is no reason whatever to assume that Union Producing Company, being a highly successful production company and with large gas and oil reserves, proven oil reserves, would ever be in a position of not being able to utilize its tax deductions.

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A. Well, certainly with respect to Union Producing Company's oil operations, those operations are in no way

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related to the activities of United, and under no theory are those operations chargeable to the customer, but rather are costs which come out of the pocket of the Gas Corporation stockholders, inasmuch as the stockholders of the Gas Corporation through Gas Corporation's ownership of the stock of Union are the ultimate stockholders that must bear any losses, profits or costs that give rise to tax deductions on Union.

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MR. SPIEGEL: He has said it generally. What I was trying to obtain in that question was what actual figures did he take from the tax return, what are the numbers? I am trying to validate and cross examine the cource of that figure.

PRESIDING EXAMINER: Mr. Dunn?

THE WITNESS: Well, you see how this is labelled depletion for tax purposes, when you go to the well-by-well basis you may find on certain wells that it is not percentage depletion for that particular year. That is, you may be limited to 50 per cent of net, or even in certain instances the figure might be a cost figure, because the 50 per cent of net was zero, so that in this depletion figure is a combination of the best advantage that the company can get

out of the tax return, namely whether it — most of it, of course, is percentage depletion, but there is a few instances where one well will be on a cost basis and another will be on a 50 per cent of net basis, and this is the total of the amounts that were actually claimed on either one of the three alternatives for the oil wells, on the one side, and the gas wells on the other.

In other words, we simply totalled the gas wells and totalled the oil wells to find out how much of the percentage depletion or tax deduction for depletion related to oil and how much related to gas, taken direct from the tax

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return.

PRESIDING EXAMINER: Do I understand that you took the total volumes of gas and oil and the revenues resulting from those volumes after you made your classification of the wells?

THE WITNESS: Well, actually the wells are set out on the tax return, itself, each time, and, of course, the wells are classified, so the tax return will show with respect to each individual well the amount claimed for percentage depletion and the production from the well, whether gas or oil, and the revenues received from such production — all the details are shown right on the schedule. The revenues, total revenues received are shown, and the computation for each respective well.

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BY MR. SPIEGEL:

Q. Well, will you give me the computation of the $5,185,647 figure shown for oil depletion for tax purposes

on Schedule No. 12 of Exhibit 14-1 beginning with whatever figures you took from the tax return direct?

A. These figures all come from the tax return direct.

Q. The $5,185,647?

A. They are the total of the oil wells, and the $7,917,361 is the total of the gas wells, from the tax return.

Q. Well, on what schedule does the figure $51,85,647 appear — on what schedule of the tax return?

A. Well, it is the details that make up the $5,185,657 that appear on the depletion schedule of the tax return. The tax return doesn't necessarily require that the taxpayer show that figure separately by simply making another schedule to add them up. However, the total is added up, and in order to find out how much related to oil and how much related to gas, it is a very feasible and direct method to add up the oil wells and add up the gas wells and find out what the direct tax deduction was for oil and what the direct tax deduction was for gas.

Q. Is that how you did it?

A. Yes, or had it done.

Q. Well, now, can you read off for me the breakdown of the numbers which you added together which appear on the

tax return which total $5,185,647?

A. Not from a summary — you don't burden the record with the detail of 1200 some wells.

Q. Are you saying there are 1200 separate figures for 1200 separate wells on the tax return, and you added those numbers together?

A. Except to the extent they might be combined on the tax return for leases, but there are a large volume of separate computations on the tax depletion schedule in the tax return.

Q. Is it a matter of simple addition of figures on the tax schedule?

A. Primarily, and understanding what you are adding.

Q. Does your use of the word "direct" in column 13, lines 22, 23 and 24 of Schedule No. 2 of Exhibit 14-1—Schedule 12—mean that you did not use any allocation prices in deriving the breakdown between oil and gas for tax depletion, confining that to line 23?

A. That is right. The basis of assignment, oil and gas, was the basis of the tax return direct charges.

Q. Can you give me the exact title of the schedule and the exact pages of the schedule of the Federal income tax return for 1961 in which there will be found the breakdown of this $5,185,647 figure?

A. No, I don't carry that sort of information around

in my head.

Q. Do you have it in your work papers with you?

A. No.

Q. Did you bring the tax return—is the tax return here?

MR. FLETCHER: It is not, and I advised you the first day it was not here, Mr. Spiegel.

MR. SPIEGEL: Mr. Examiner, I must at this time move to strike this exhibit on the grounds that it is unsupported by probative testimony which shows the way in which these figures which are alleged to come from the tax return have come from the tax return and been utilized in this case.

In other words, there is an absence of proof, and an inability on their part to explain on cross examination and justify the foundation of those figures.

MR. FLETCHER: Do you care to hear from me on that?

PRESIDING EXAMINER: Yes, Mr. Fletcher.

MR. FLETCHER: The motion of course is without any merit whatsoever. The exhibit is fully explained, the source of the figures is fully explained. Now, the real point of the motion is not a motion to strike the exhibit, but for some reason counsel wants to try to force the production of the tax return in this hearing room, a matter that is not at all necessary.

The exhibit is fully explained and the source of the

figures is explained and the figures are vouched for, and nothing has appeared which brings into question a single solitary figure in the exhibit. The evidence is fully sufficient, and the motion in my opinion is without any merit.

PRESIDING EXAMINER: I am going to deny the motion.

BY MR. SPIEGEL:

Q. Mr. Dunn, referring to Exhibit 14-1, Schedule 12, line 23, can you tell me of the total shown in column 9 of $13,103,008 how much of that depletion is applicable to condensate wells?

A. Oh, no, I did not attempt to break this down other than between gas wells and oil wells, or attempt to classify a gas well as again a condensate gas well or some other kind of a gas well, which classification I don't know even exists.

Q. Well, tell me where is the depletion which is referable to condensate liquids placed as between the column headed "Oil" and the column headed "Gas", columns 10 and 11?

A. Where did you ever hear of any depletion applicable to condensate liquids? Where did that figure ever come from? Out of the blue?

PRESIDING EXAMINER: Well, I take it there is no such classification in this exhibit.

THE WITNESS: No.

PRESIDING EXAMINER: All right.

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BY MR. SPIEGEL:

Q. Do your total revenues shown on line 1, column 1 of $52,891,396 include revenues for condensate liquids?

A. Revenues —

Q. Schedule 12, Exhibit 14-1.

A. Yes.

Q. Well, now, isn't it true that in 1961 there was depletion for tax purposes related to the revenues received from condensate liquids — isn't that true?

A. I would have to check on whether or not the condensate, which is something that is derived from the gas after it is produced from a well in the gas stream was or can be reflected in a percentage depletion computation. I don't recall seeing — from going through the tax returns — any computation for a figure representing revenues received from products obtained from the gas after production.

I can check as to just how that is handled in the tax returns for you. I don't recall at the moment.

Q. Will you be able to check over the lunch hour?

A. I can't give you numbers, but I can tell you how the percentage depletion is computed with respect to the gas produced from the gas wells.

Q. Well, do you know the breakdown of operating revenues or the amount included in operating revenues on Schedule No. 12, line 1, for condensate liquids?

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A. I believe that is shown in the excluded exhibits in this case, yes.

Q. Well, I am now referring to Schedule No. 12, line 1, column 1, and I am asking you how much of that, if you know, is liquid condensate?

A. Well, as I say, those figures were all set out in the detailed schedules on Union showing revenues, allocations, tax deductions, which are the excluded exhibits in this case,

and I do know that they are shown on there. I would have to look at the excluded exhibits and read from them to tell you the amounts.

Q. I just asked you for one amount. I am asking you how much the condensate liquid revenue is within $52,891,396 shown on line 1, column 1, if he knows.

MR. FLETCHER: I submit he has answered that.

BY MR. SPIEGEL:

Q. Do you know?

A. Well, not without referring to the exhibit that was excluded, which contains that information.

Q. I am not asking you where you go — I am asking do you know.

MR. FLETCHER: He just wants to use the excluded exhibit.

PRESIDING EXAMINER: He has answered the question that he knows, if he can refer to the exhibit.

MR. FLETCHER: That is right.

MR. SPIEGEL: I am asking him how much it is.

MR. FLETCHER: Do you want him to refer to the excluded exhibit?

PRESIDING EXAMINER: Do you want him to put this figure in the record?

MR. SPIEGEL: I would like this figure in the record. Maybe he has it in his workpapers.

PRESIDING EXAMINER: Is there objection?

MR. FLETCHER: Yes, I object to it unless he instructs the witness to use the excluded exhibit which the witness says is the source of the information.

PRESIDING EXAMINER: It seems to me that is obviously necessary for the witness to answer the question.

MR. FLETCHER: But when I ask him to be sure we didn't get in a hassle down the way about it, he evaded the question and did not answer it.

PRESIDING EXAMINER: Counsel, I don't want to get into an argument between counsel on this.

Mr. Dunn, can you obtain this figure —

MR. FLETCHER: It is agreeable to me, Mr. Examiner, it is notrouble to me. I am quite agreeable for him to refer to the exhibit and get the number.

PRESIDING EXAMINER: I understand that this is the purport of the question.

MR. SPIEGEL: Of course, I am not trying to bring

that exhibit in. Maybe I can ask a preliminary question.

BY MR. SPIEGEL:

Q. Is there any other place in your working papers that you are able to determine, without going to the exhibit, the total number of operating revenue dollars for condensate liquids for the year 1961 which is included within the figure of $52,891,396 — is there any place you can find it in your working papers, except by going to the excluded exhibits?

PRESIDING EXAMINER: We don't have to get into a hassle about the excluded exhibits. You have asked him a question about a figure. If the witness can get this figure, he can put it in the record, period.

MR. SPIEGEL: That is fine with me. I just don't want them throwing that exhibit in on me.

PRESIDING EXAMINER: We don't need to get in a discussion about that. If the witness can supply the figure, it can be put into the record. If he can't find it, it can't be put into the record.

Suppose we recess at this time.

(Whereupon, at 12:31 p.m., the hearing was recessed until 2:00 p.m., the same day.)

AFTERNOON SESSION

2:00 p.m.

PRESIDING EXAMINER: May we come to order, please. Whereupon,

E. L. DUNN

resumed the stand, and having been previously duly sworn, was examined and testified further as follows:

THE WITNESS: I believe you had asked me if I could give you a breakdown of the operating revenues between oil, gas and condensate.

Now, those operating revenues are from the financial statements of the books, and I have this much of a breakdown available.

For the year 1961, natural gas sales totaled $26,288,244. Gasoline and extracted production, $7,369,915.

Crude oil totaled $19,233,238.

The total of those three categories, $52,891,397, shown on line 1, Schedule 12 of Exhibit 14-1.

CROSS EXAMINATION (Resumed)

BY MR. SPIEGEL:

Q. Well, the question that I am asking is what is the revenue derived from condensate liquids in 1961?

A. The gasoline figure of $7,369,915 includes condensate sales and products extracted from condensate and from the gas stream which was not reduced to condensate. That is a combination figure of the liquids obtained from the

gas stream.

Q. Is the tax depletion applicable to that $7,369,915 of liquids included in your figure of $4,185,647 labeled "Oil," and Schedule 12 of Exhibit 14-1, line 23, column 10?

MR. FLETCHER: That is 5, not 4 — 5 million.

BY MR. SPIEGEL:

Q. $5,185,647.

A. No, whatever depletion is derived from the products obtained from the gas stream from gas wells is included as gas depletion.

Q. In other words, you have classified all condensate leases as gas leases in lines 22 through 24 of Schedule No. 12 of Exhibit 14-1 in the columns 6 through 13?

MR. FLETCHER: My objection to that, Mr. Examiner, is in the first place there is no such thing as a condensate lease, and, in the second place, the law is very well settled that what we call condensate and sometimes call also natural gasoline and other liquids extractable from gas are, by judicial decision gas.

PRESIDING EXAMINER: All right, I will sustain the objection as to the form insofar as it relates to the exhibit.

BY MR. SPIEGEL:

Q. Does the figure of $7,917,361 appearing on Schedule 12 of Exhibit 14-1, line 23, column 11, include all wells

classified as gas wells by state authorities even though they produce condensate as well as gas?

A. They include all the gas wells classified as gas wells by the respective state regulatory authorities, and those wells produce gas from which condensate is recovered after production, and those figures are all reflected in the $7,917,361 to which you refer.

Q. Now, does the figure of $5,185,647 appearing on line 23 of column 10 of the same schedule include all wells classified by state authorities as oil wells irrespective of whether they produce natural gas, in addition?

A. What do you mean by irrespective? They are classified as oil wells because they produce oil. Now, some of those wells produce some casinghead or solution gas which is something less than three per cent of the total gas sales, but that casinghead gas recovered from an oil well does not mean — does not make it a gas well irrespective of the

fact it produces oil — it is simply an oil well; and casinghead gas comes from an oil well.

Q. Do you know whether Union Producing has any multiple completion wells?

MR. FLETCHER: Now, is Union in or is Union out?

PRESIDING EXAMINER: I am going to sustain the objection.

MR. SPIEGEL: On what grounds, sir?

PRESIDING EXAMINER: On the ground it is irrelevant

and immaterial.

MR. SPIEGEL: No. The multiple completion wells he is allocating between oil and gas. A multiple completion well may produce both oil and gas and I am trying to find out how he has allocated it for purposes of this exhibit. I don't know what Mr. Fletcher is laughing about.

MR. FLETCHER: This is no allocation, Mr. Examiner.

MR. SPIEGEL: I am trying to find out — this is the purpose of cross examination, and I don't see how a chuckle from counsel table —

PRESIDING EXAMINER: Mr. Spiegel, my understanding is that the witness has explained exactly what he has done in this exhibit, and I have no objection to your cross examining him in as much detail as necessary to ascertain what he did, but when you start asking questions which are addressed to Union, we are getting into another area, and I don't want to open that door.

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Now, let's confine your examination to this exhibit.

MR. SPIEGEL: You are aware that this exhibit is Union Producing. The only figures on this exhibit are Union Producing figures.

PRESIDING EXAMINER: All the figures on this exhibit are from Union Producing?

MR. SPIEGEL: Yes, sir.

MR. FLETCHER: No, that is not so.

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MR. SPIEGEL: I am sorry, I mean this Schedule No. 12 is an allocation of costs between oil and gas, or deductions for Union Producing only.

PRESIDING EXAMINER: As I understand, the witness has said a number of times that he has taken the total volumes and sales attributable to oil and total volumes and sales attributable to gas to produce these figures based on the existing classification of the wells as oil or gas, isn't that correct?

MR. FLETCHER: Yes, sir, and in addition, Mr. Examiner, counsel overlooks the fact that this is a rebuttal exhibit. This is not Union's main case — it is a rebuttal exhibit, in rebuttal to his own exhibit on tax and to the staff's exhibit on tax.

MR. SPIEGEL: I might say I have a number of questions, but not very many, which are trying to find out exactly what was done in this portion of the exhibit.

PRESIDING EXAMINER: Well, as I indicated, you may go ahead on that line.

BY MR. SPIEGEL:

Q. On line 23, column 9, of the same schedule, you show intangible drilling costs —

MR. FLETCHER: Not line 23.

BY MR. SPIEGEL:

Q. I am sorry, line 24, column 9, intangible drilling

cost of $4,154,579, and my question is, is a portion of those drilling costs associated with multiple completion wells?

A. Not to my knowledge. I don't think Union has any what might be called multiple completion wells, but if they do, it would only be one or two

Q. Wasn't that something that you had to know in order to prepare the material shown on Schedules 12, 11, 10, 9 and 8 for the spreading of intangible drilling costs as between oil and gas?

A. They weren't spread, they were taken directly from the tax return and supporting papers, and they were from those wells classified as oil wells with those wells classified as gas wells.

PRESIDING EXAMINER: For my benefit, Mr. Dunn, would you tell me briefly what you mean by multiple completion wells?

THE WITNESS: In recent years, on very deep wells, there has been a technique developed to run various strings of tubing in the wells which permits one string of tubing to produce oil from one level and another string of tubing to produce gas from another horizon.

MR. FLETCHER: Or several different types of either.

THE WITNESS: And sometimes there have been as many as seven sources of production — some of these very deep wells go through as many as seven different producing

horizons, and this technique has been developed on the very, very deep wells.

MR. SPIEGEL: I believe there is a question outstanding, sir.

PRESIDING EXAMINER: I don't think so.

MR. SPIEGEL: Yes, I asked him a question about those completions, and then you asked him that question.

PRESIDING EXAMINER: No, he answered your question before I asked — do you want his answer read back?

MR. SPIEGEL: Yes, would you read the question and answer just before the Examiner's question?

(The question and answer were read.)

BY MR. SPIEGEL:

Q. It is my understanding, then, that you simply took the classifications as they appeared on the documents you mentioned, and did not analyze and go behind them, is that correct?

A. Well, they are classified on those documents according to state regulatory commission requirements, and, of course, I didn't go behind any state regulatory commission requirements.

Q. Now, included in the figure of $1,489,756 on line 24, column 10, are intangible drilling costs for wells which produce casinghead gas as well as oil, is that correct?

MR. FLETCHER: Now, Mr. Examiner, I am going to object to that. We have been through this, and he has told him

that casinghead gas came from an oil stratum.

PRESIDING EXAMINER: He has answered —

MR. SPIEGEL: No, I am asking him about intangible drilling costs. I have asked him some figures about depletion costs, and now I am asking the question about intangible drilling costs. We have not been over this.

I have a very short examination on this, but these are allocations which could be cross examined for weeks — I don't want to do that.

PRESIDING EXAMINER: I don't want to waste any more time, well, spend any more time than we have to.

You may answer the question, I take it to the extent casinghead gas is produced from oil wells, the answer would be the same.

THE WITNESS: It would.

MR. SPIEGEL: I can't make sense out of that. Let me ask my question.

PRESIDING EXAMINER: Go ahead with your question.

MR. SPIEGEL: I am not abusing the witness.

BY MR. SPIEGEL:

Q. I am asking you whether in connection with the intangible drilling cost shown on line 23, column 10, as $1,489,756 — I am asking you whether that includes intangible drilling costs for wells which are classified as oil wells but nonetheless produce casinghead gas?

PRESIDING EXAMINER: All right, he may answer.

THE WITNESS: The answer is yes, to the extent that any casinghead gas is produced by the oil wells in that column, the cost, intangible drilling cost is classified under oil.

MR. FLETCHER: Again, Mr. Examiner, the cases again hold that casinghead gas is oil.

MR. SPIEGEL: I must object to counsel making some kind of legal argument at this time.

MR. FLETCHER: I am not making a legal argument. You know that just as well as I know it and you are not surprised.

PRESIDING EXAMINER: Please, counsel, let's proceed with the interrogation.

BY MR. SPIEGEL:

Q. Focusing on line 23, column 11, the amount of $2,664,823 for intangible drilling costs for gas, will that include intangible drilling costs for wells classified as gas wells, but nonetheless producing condensate?

A. They produce gas from which condensate is extracted after production.

Q. Then you have not taken out of that figure any costs associated — any intangible drilling cost associated with condensate, is that correct?

A. I haven't taken anything out of that figure. It is

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the intangible drilling cost of gas wells, with nothing taken out.

Q. Are you aware of the fact that the state pro-ration classifications as between oil and gas are different in the different states in which Union Producing operates?

A. I, myself, am not particularly familiar with the state pro-ration laws in the respective states — state classification laws, rather.

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Q. Can you accept that figure subject to check?

A. Well, as I understand what you did, you took the combination of depletion from oil properties and depletion from gas properties, and a combination of depreciation from oil properties and depreciation from gas properties and the intangible drilling costs from oil properties and intangible drilling costs from gas properties, and added them together for each of the respective years, and then added the three items together to get a total.

Then you took the figure recorded as book depreciation and depletion for that year and each of the other years respectively, and deducted those figures from the tax depreciation and depletion and intangible drilling cost to arrive

(3389)

at the difference that you mentioned, namely $74,381,851, shown on the workpaper you gave me, and that figure is the arithmetical result of that process of computation.

I would like to say this, that depletion figures are directly related to the prices received for gas and oil

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respectively, and, of course, if any of the prices in those years are in any way changed, then we are faced with a depletion adjustment on the tax return with respect to that deduction.

Of course, I also don't want my agreement that the book depreciation and depletion figures are necessarily all of the costs of depreciation and depletion related to Union's properties on the basis of spreading the properties in proportion to the gas or oil produced and, incidentally, those book figures that you read were a combination of gas and oil properties, also.

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MR. BERKELEY: We will be glad to stipulate with you that the use of the consolidated tax technique will give to the benefit of United Gas Pipe Line customers, if you look at consolidated taxable income and actual consolidated tax, an effective tax rate lower than 52 per cent, and that this results from taking into account Union's losses on oil as well as Union's losses on gas.

MR. FLETCHER: Do I understand that the stipulation also includes that it was the intended purpose of the staff

to take those benefits and give them to the customers of United Gas Pipe Line Company?

MR. BERKELEY: It was that purpose, to the extent that it reflects the actual effective tax rate paid by the three companies that participate in the tax return, yes.

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Excerpt from testimony of Kenneth L. Smith, witness for Memphis Light, Gas and Water Division —

Direct Examination

PRESIDING EXAMINER: Well, I wish you would make your position clear. I might add, in making your position clear, I am interested in knowing whether in your view it is at all material or of any significance at all in the consolidated return as to how the losses or gains are produced, whether they are produced by a subsidiary being in the manufacturing of toys, or whether or not you are concerned at all as to what the effect of the process is, and, if so, to what extent is it material, significant, etc., etc.

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THE WITNESS: I do think that it is material, and I have given this matter a great deal of study over the last five or six years. In fact, I suspect it has pre-occupied my time, or more of my time than any other one object during that period of time.

The reason that I think it is material and relevant, and the reason that I think that the oil, the losses that might be assignable to oil or some other operation must be considered, goes back to the fact that we are attempting to regulate

here on a cost of service basis which includes a fair return on the investment, and we know that the costs that are actually incurred for the taxes of the consolidated group, and relating that to cost of service, of course we make a computation to try to reflect the taxes which would be incurred on the basis of a given rate of return allowance.

We know that by the very nature of things that that cost is a joint cost of the consolidated group. It has to be allocated. The very fact that United, as shown quite clearly in the record in this case, United Gas Corporation and its subsidiaries allocate that cost among themselves. That gets us to a cost basis for taxes, and we can quite readily express that cost basis when we use the effective tax rate which actually governs the amount of tax allocated to any one company such as United Gas Pipe Line in relation to its taxable income.

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Now, there is another facet to this that is very important and is very frequently overlooked, but I believe there is a great deal of support for considering it as a part of this one ball of wax.

When the Commission goes to the very vital problem, one of the most important in the rate case, of fixing the rate of return for United Gas Pipe Line, it looks at the rate of return that is required by United Gas Corporation as the vehicle through which much of the financing, if not all of it for the pipe line company and the whole operation is done, and it has to give recognition to the cost of capital in terms of contractual debt, and to the — in terms of the demands of investors in the equity securities which can only be measured through the holding corporation, the

top company, and therefore when the Commission decides a rate of return, the only standard that it has to go by is the standard provided by the vehicle of the financing of this group.

Now, I believe in Your Honor's question he referred to non-related, non-utility operations that might be a part of a consolidated tax return.

PRESIDING EXAMINER: Did I follow you so far, and correct me if I am wrong, that what you are saying in substance is that in the consolidated return you don't believe that a meaningful segregation of costs can be made? In other words,

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you don't really believe that a segregation of costs solely attributable to gas operations can be made?

THE WITNESS: With respect to the rate of return. I don't believe the Commission has ever been able to make it.

PRESIDING EXAMINER: Well, what about the situation of the non-related, non-utility operation, or subsidiaries?

THE WITNESS: Well, it is my belief that any operation that is included in the consolidated group has an effect on the — an ultimate effect on the rate of return for that group. It seems to me it is bound to.

PRESIDING EXAMINER: So that you would include a subsidiary that was manufacturing toys, let's say, so long as it participated in the consolidated return?

THE WITNESS: You mean for the purpose of —

PRESIDING EXAMINER: For the purpose of computing your effective rate, taking the tax losses of the toy

subsidiary in computing your effective rate for the regulated gas utility whose cost of service is the problem that is before the Commission.

THE WITNESS: If this was continuing, recurring tax loss which — and I could only — it poses a difficult question, because having a subsidiary of that kind and retaining it indefinitely by a holding company, by a utility system, a utility company group, poses a much different problem situation to me than having related oil operations, for example,

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which are not in a loss position so far as ordinary financial reporting is concerned — they are profitable operations, but they have a tax loss, and I am assuming that the rate of return fixed by the Commission and applied to the utility operation by the very nature of things is a composite of what the investor thinks of the enterprise as a whole, and if —

PRESIDING EXAMINER: And by the enterprise as a whole, do you mean all of the companies of the system, including all companies participating in the consolidated return regardless of the nature of the operation, whether regulated or not regulated by the Federal Power Commission?

THE WITNESS: Yes, and I am making one further assumption that the financing of these subsidiaries is through one vehicle, so that the financing of them, their going into the market for capital, can't be separated and is not in practical effect separated from that of the utility operation. I think that is one of the conditions that must be

present in my treatment here, and certainly it is present in this case.

Now, if there were a way, which the Commission I don't believe has been able to evolve — if there were a way in which the Commission could separate the rate of return for the utility business and put a rate of return on that business exclusive of all the other facets of a business that enter into the composite group, then I would give reconsideration to this matter of dividing up the tax cost

for the group, but I can't see any rational basis under which a regulatory commission could provide an incentive, and I believe it would be doing that if it did not recognize the impact of these tax losses on the composite picture, if they say "we will give you a tax allowance which disregards the fact that tax savings and tax reductions are provided through the tax losses of subsidiaries or related companies", and at the same time were unable to separate the cost of capital for the exclusive utility operation, what I think would be happening is that through the regulatory process the consumers of gas or electricity, or whatever it might be, would be validating the benefits of tax losses in such a way as to give — and by the benefit of a tax loss I simply mean there is a tax saving to somebody that has got to be accounted for or has to be somewhere in the scheme of things, as somebody is going to get the benefit of that tax saving, that is basic to this — that if validated that through the regulatory process by allowing taxes which would not be paid, it would in effect be allowing more than the fair rate of return which it was purporting to allow, and I believe it would be erroneous

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6–1	From UGPL Co. Ex. 6-1, Union Producing Company Statement of Income and Capital by Years, 1952 through 1961, (Schedule No. 1)	4	(5669)
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IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

UNITED GAS PIPE LINE COMPANY, *Petitioner,* v. FEDERAL POWER COMMISSION, *Respondent,* CITY OF MEMPHIS and MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL, *Intervenors.*	No. 21872
UNITED GAS PIPE LINE COMPANY, *Petitioner,* v. FEDERAL POWER COMMISSION, *Respondent,* CITY OF MEMPHIS and MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL, *Intervenors.*	No. 21958

JOINT APPENDIX

Volume II

Transcript of Exhibits and Decisions

(Joint Appendix Pages 1 to 55;

Record Pages 5242 to 9166)

5242 **Exhibit 2-25, United Gas Pipe Line Company Statement H(1)-4b-Account 922-Administrative Expenses 12 months ending 3/31/62 (Schedule H(1)-4b).**

Statement # 1
Schedule H(1)-4b

	Initials	Date
Prepared By		
Approved By		

United Gas Pipe Line Company
Account 922-Administrative Expenses Transferred-Credit

The activities of the Plant Accounting Department consist of general office accounting for Completed Construction Work in Progress, accounting for Plant in Service and retirements thereof, General Supervision of field accounting for Construction Work in Progress, recording in detail Current transactions affecting figures previously developed in connection with the ascertaining of the original cost of gas Plant and Other Properties, and Preparation of necessary Statements and Inventories relating thereto. The expenses of this department include the salaries, traveling and other expenses of the department head, his assistants, engineers, accountants and other departmental employees.

The expenses of this department which are applicable generally to the natural gas operations of United Gas Corporation, United Gas Pipe Line Company and to the Natural Gas and Crude Oil Operations of Union Producing Company are distributed to these Companies on the basis of a study of the time devoted to the accounting for such Companies, such time being segregated between accounting for Construction Work in Progress and accounting for Plant in Service. That portion of the time devoted to accounting for Construction Work in Progress is charged to Plant account and that portion of the time devoted to accounting for Plant in Service is charged to Operating Expenses.

Accounting for the expenses of the department was as follows:

Salaries		$ 250,119
Expenses of General Officers and Employees		239
Computer Expenses		708
Office Supplies and Expenses		2,560
1/ Maintenance of Office Furniture and Equipment		4,362
Total Gross Expense		$ 254,988
Less Amount Charged to Associated Companies:		
Union Producing Company	$ 80,975	
United Gas Corporation	8771	89,446
Amount Charged to United Gas Pipe Line Company		165,542
2/ Amount Credited to Acct. 922 Admin. Exp. Transferred-Credit		81,328
Balance of Admin. and Gen. Expenses		$ 84,014

1/ Maintenance Contracts on Office Machines
2/ Contra Account-Construction Work in Progress

United Gas Pipe Line Company Exhibit 2-36. Statement H(3)a, Federal Income Tax 12 months ending 3/31/62, adjusted.

STATEMENT NO(3)
SCHEDULE NO(3)-A

	Initials	Date
Prepared By		
Approved By		

UNITED GAS PIPE LINE COMPANY
FEDERAL INCOME TAXES
12 MONTHS ENDED MARCH 31, 1962 - ADJUSTED

LINE NO.	DESCRIPTION	(1)	(2)	(3) STATEMENT REFERENCE	(4) AMOUNT
1	RETURN ON RATE BASE AT 6.5%				25 197 877
2	OTHER INCOME				141 [illegible]
3	GROSS INCOME				25 [illegible]
4					
5	INCOME DEDUCTIONS				9 [illegible]
6					
7	NET INCOME				16 [illegible]
8					
9	OTHER INCOME AND NONDEDUCTIBLE DEDUCTIONS				
10	FEDERAL INCOME TAXES				12 099 662
11					
12	OTHER DEDUCTIONS AND NON-TAXABLE INCOME				
13	85% OF DIVIDENDS RECEIVED				27 [illegible]
14	TO ADJUST DEPRECIATION EXPENSE TO TAX BASIS				3 [illegible]
15	INTEREST DURING CONSTRUCTION				[illegible]
16	TO ADJUST BOND DISCOUNT AND EXPENSE TO TAX BASIS				7 695
17	LOSS ON ABANDONMENTS				89 117
18	DECREASE IN INVENTORY ADJUSTMENT RESERVE				47 179
19	EMPLOYEE BENEFITS CAPITALIZED				348 200
20	AMORTIZATION OF FRANCHISE				124
21	DEPLETION ALLOWANCE				816 21
22	CLEARING ACCOUNTS				47 627
23	TAXES CAPITALIZED				130 115
24	TOTAL OTHER DEDUCTIONS AND NON-TAXABLE INCOME				4 941 137
25					
26	NET TAXABLE INCOME				23 279 [illegible]
27					
28					
29	COMPUTATION OF FEDERAL INCOME TAXES				
30	52% OF NET TAXABLE INCOME				12 [illegible]
31	LESS SURTAX EXEMPTION				[illegible]
32	TOTAL FEDERAL INCOME TAXES				12 099 662
33					
34					
35					
36	NOTE: COMPANY DOES NOT CLAIM DEDUCTION				
37	FOR LIBERALIZED DEPRECIATION NOR				
38	ACCELERATED AMORTIZATION.				
39					
40					
41					
42					
43					

5669 : **United Gas Pipe Line Company Exhibit 6-1. Union Producing Company Statement of Income and Capital by years 1952 through 1961 (Schedule No. 1).**

UNION PRODUCING COMPANY

STATEMENT OF INCOME AND CAPITAL, BY YEARS
1952 THROUGH 1961

Line No.		(1) Total (10 Years)	(2) 1961	(3) 1960	(4) 1959	(5) 1958	(6) 1957	(7) 1956	(8) 1955	(9) 1954	(10) 1953	(11) 1952
	Operating Revenue											
1	Natural Gas	$ 219,358,305	$ 26,288,244	$ 26,215,423	$ 27,268,343	$ 27,044,934	$ 23,773,983	$ 23,122,375	$ 19,380,938	$ 16,427,407	$16,296,251	$13,540,407
2	Gasoline	84,249,519	7,369,915	8,033,152	8,782,503	9,425,928	9,424,478	8,494,738	8,179,487	7,977,362	8,750,039	7,811,917
3	Crude Oil	189,316,578	19,233,238	19,444,595	19,978,063	20,362,751	22,535,572	20,081,233	19,916,891	16,149,732	15,429,118	16,185,385
4	Total	492,924,402	52,891,397	53,693,170	56,028,909	56,833,613	55,734,033	51,698,346	47,477,316	40,554,501	40,475,408	37,537,709
	Revenue Deductions											
5	Operating Expenses	175,355,543	18,423,101	18,824,817	19,737,226	18,553,525	19,290,926	17,523,781	18,473,021	16,218,646	15,153,289	13,157,211
6	Depreciation and Depletion	60,000,000	7,900,000	7,400,000	6,600,000	6,700,000	6,400,000	6,300,000	5,500,000	4,500,000	4,500,000	4,200,000
7	Dry Holes	39,514,032	2,208,612	5,956,340	5,623,289	2,510,761	5,212,985	2,389,165	5,002,613	3,945,154	3,052,927	3,612,186
8	Unproven Leases Abandoned	24,019,193	4,297,734	2,985,850	2,648,666	2,619,532	2,994,938	1,931,005	2,422,655	1,656,327	1,308,001	1,154,485
9	Other Taxes	46,075,326	5,337,031	4,771,614	5,723,175	5,676,534	5,141,693	4,861,646	4,583,860	3,809,855	3,177,254	2,992,664
10	Federal Taxes	1,131,428	(280,815)	137,529	116,812	95,934	35,936	(272,281)	1,829	76,637	446,218	773,629
11	Total	346,095,522	37,885,663	40,076,150	40,449,168	36,156,286	39,076,478	32,733,316	35,983,978	30,206,619	27,637,689	25,890,175
12	Operating Income	146,828,880	15,005,734	13,617,020	15,579,741	20,677,327	16,657,555	18,965,030	11,493,338	10,347,882	12,837,719	11,647,534
13	Other Income	227,988	43,449	68,834	20,200	20,395	13,200	10,497	9,375	(9,036)	25,578	25,496
14	Gross Income	147,056,868	15,049,183	13,685,854	15,599,941	20,697,722	16,670,755	18,975,527	11,502,713	10,338,846	12,863,297	11,673,030
	Income Deductions.											
15	Interest on Debentures	20,400,000	2,040,000	2,040,000	2,040,000	2,040,000	2,040,000	2,040,000	2,040,000	2,040,000	2,040,000	2,040,000
16	Interest on Other Long-Term Debt	4,722,983	102,812	43,752	276,262	434,326	617,946	779,038	920,046	815,145	458,533	275,123
17	Other Interest	42,987	140	982	2,451	710	244	139	9,094	14	2,017	27,196
18	Interest Charged to Construction - Cr.	623,877	45,788	65,478	112,559	111,630	55,800	45,704	53,778	68,189	34,033	30,918
19	Other Deductions	1,093,396	98,316	96,657	117,821	84,391	209,988	82,930	63,238	189,713	82,314	68,028
20	Total	25,635,489	2,195,480	2,115,913	2,323,975	2,447,797	2,812,378	2,856,403	2,978,600	2,976,683	2,548,831	2,379,429
21	Net Income	121,421,379	12,853,703	11,569,941	13,275,966	18,249,925	13,858,377	16,119,124	8,524,113	7,362,163	10,314,466	9,293,601
22	Rate of "Return" Earned (line 12 ÷ by line 32)	10.92%	8.41%	8.17%	9.94%	13.70%	11.69%	14.15%	9.16%	9.53%	13.68%	13.40%
	Capitalization at End of Year											
23	Debentures	340,000,000	34,000,000	34,000,000	34,000,000	34,000,000	34,000,000	34,000,000	34,000,000	34,000,000	34,000,000	34,000,000
24	Advances from Affiliates	107,800,000	1,800,000			5,000,000	12,000,000	16,000,000	22,000,000	22,000,000	17,000,000	12,000,000
25	Misc'l Long-Term Debt	3,936,456	168,876	222,557	252,434	367,899	356,180	431,592	528,086	460,794	568,387	579,651
26	Total Debt	451,736,456	35,968,876	34,222,557	34,252,434	39,367,899	46,356,180	50,431,592	56,528,086	56,460,794	51,568,387	46,579,651
27	Common Stock	722,500,000	124,000,000	124,000,000	103,500,000	87,000,000	75,000,000	60,000,000	52,000,000	42,000,000	27,500,000	27,500,000
28	Capital Surplus	2,384,950	238,495	238,495	238,495	238,495	238,495	238,495	238,495	238,495	238,495	238,495
29	Earned Surplus	217,392,356	23,320,380	14,966,678	21,896,737	27,120,771	26,541,408	26,081,171	22,458,129	20,924,539	18,307,742	15,774,801
30	Total Equity	942,277,306	147,558,875	139,205,173	125,635,232	114,359,266	101,779,903	86,319,666	74,696,624	63,163,034	46,046,237	43,513,296
31	Total Capitalization	1,394,013,762	183,527,751	173,427,730	159,887,666	153,727,165	148,136,083	136,751,258	131,224,710	119,623,828	97,614,624	90,092,947
32	Average Capitalization	1,344,147,143	178,477,741	166,657,698	156,807,416	150,931,624	142,443,671	133,987,984	125,424,269	108,619,226	93,853,786	86,943,728
33	Dividends Paid	112,800,000	4,500,000	18,500,000	18,500,000	17,800,000	13,400,000	12,500,000	7,000,000	4,800,000	7,800,000	8,000,000
34	Sales of Common Stock	96,500,000		20,500,000	16,500,000	12,000,000	15,000,000	8,000,000	10,000,000	14,500,000		

( ) Indicates red figure

6209-6226 **United Gas Pipe Line Company Exhibit 14-1 — Summary of Taxable Income — Years 1957 through 1961, inclusive, recited to reflect adjustments as indicated by detailed schedules — Schedules 1 through 13, inclusive.**

Schedule No. 1

	Amount	Date
Prepared By		
Approved By		

United Gas Pipe Line Company

Summary of Actual Taxable Income Per Returns or Revenue Agents' Reports, as Adjusted, Allocated Consolidated Federal Income Tax and "Effective Tax Rates" - 1957-1961 Inclusive

Line No.	Years	(1)	(2) Taxable Income of U.G.P.L. Co.	(3) Consolidated Tax Allocated to U.G.P.L. Co.	Effective Rate (Ratio of Col (3) to Col (2))
1					
2	1957		$17477936	$8975774	48.210%
3					
4	1958		17778707	10781188	60.637%
5					
6	1959		16980187	8596179	50.625%
7					
8	1960		14167603	6691601	47.232%
9					
10	1961		20511046	10483406	51.111%
11					
12	6 Totals		$86914779	$44777266	51.519%
13					
14	7 5-Year Average		$17382936	$8955453	51.519%

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6210

Schedule No. 2

	Initials	Date
Prepared By		
Approved By		

United Gas Corporation and Subsidiaries
Statement of 5 Year Average Taxable Income Realized to
Reflect Certain Adjustments as Indicated by Detailed Schedules

Year	Taxable Income Total	Taxable Income United Gas Corporation	Taxable Income to Consolidated United Gas Pipeline Co.	Taxable Income to Consolidated Union Producing Co.	United Gas Pipeline Co. Reduction Amt.
1957	$ 17,017,881.	$ 2,058,350.	$ 17,777,236.	$ (1,818,711.)	-
1958	24,815,376.	2,464,704.	17,778,767.	4,571,905.	-
1959	18,833,980.	2,915,169.	16,980,167.	(1,061,356.)	-
1960	21,685,304.	1,951,033.	21,167,503.	(1,433,232.)	-
1961	20,180,588.	(691,136.)	20,511,010.	360,648.	-
Total	$ 102,533,129.	$ 8,698,120.	$ 94,214,683.	$ (420,674.)	-
Average	$ 20,506,626.	$ 1,739,624.	$ 18,842,937.	$ (84,135.)	-
Separate Return Basis Tax @ 52% of Line 1d		$ 904,604.	$ 9,797,927.	$ 43,790.	-
Less: $ 25,000 Surtax Credit		25,000.	25,000.	25,000.	-
Tax Liability Separate Return Basis		$ 879,604.	$ 9,772,927.	$ 18,790.	-
Consolidated Tax @ 52% of Line 1d	$ 10,657,537.				
2% Additional Consolidated Tax	495,988.				
Less: $ 25,000 Surtax Credit	25,000.				
Total Consolidated Tax Liability	$ 10,653,125.				
Ratio of each Company's Separate Taxable Income to Aggregate of Consolidated Taxable Income of Companies Having Taxable Income	100.000%	10.424%	88.997%	.579%	
Allocation of Consolidated Tax (Above %) to Companies (Based on Line 2a)	$ 10,653,125.	$ 1,064,357.	$ 9,836,970.	$ 51,797.	

	Consolidated Tax	Separate Return Tax	Excess Separate Return Tax over Consolidated Tax
United Gas Corporation	$ 1,064,357.	$ 879,604.	
United Gas Pipe Line Co.	9,836,970.	9,772,927.	
Union Producing Co.	51,797.	18,790.	
Total	$ 10,953,125.	$ 10,671,321.	$ (281,804.)
Savings %			(.02657)

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Schedule No. 3
Page 1 of 2

Prepared By		
Approved By		

United Gas Corporation and Subsidiaries
Computation of Consolidated and Separate Returns Basis Federal Income Tax, Adjusted
Year 1957

	Consolidated Totals	Eliminations Other	Eliminations Dividend Adjustment	Total Separate Returns Basis	United Gas Corporation	United Gas Pipe Line Company	Union Producing Company
Net Taxable Income (Per Books of Operating Report)					17,090,424.	25,708,093.	(2,779,999).
Adjustments:							
Unions Producing Company Depletion Less (Gain)							97,221.
Rate Refunds: Federal Power Commission					513,103.	(513,103.)	
To Customers					(513,103.)		
Taxable Income Per Books Operating Report Adjusted					17,090,424.	25,708,093.	(2,779,999).
Taxable Income:							
United Gas Corporation	$ 3,061,950.				17,090,424.		(14,028,474).
United Gas Pipe Line Company	17,777,724.		1,553,000.	19,330,724.		19,330,724.	
Unions Producing Company	(14,028,474).	(1) 16,970.	27,222.	17,570,222.		17,570,222.	
Total	6,811,200.	(2) 22,222.		(14,028,474).			(14,028,474).
Less: 85% of Dividends	97,222.	(3) 87,222.	1,637,610.	5,600,282.	17,090,424.	17,570,222.	(14,028,252).
Capital Gains				14,041,448.	14,013,948.	27,222.	22,222.
Capital Loss Carryover				182,282.	160,782.	21,500.	
Net Capital Gains				(160,782.)	(160,782.)		
				87,222.		65,000.	22,222.
Revised Taxable Income exclusive of Dividends and Capital Gains	19,047,581.			21,348,544.	5,339,321.	17,777,724.	(1,768,101).
Tax @ 52%	9,904,742.			11,099,243.	2,776,447.	9,243,916.	
Less: 1.5% Dividend Credit	57,000.			111,000.	56,000.	55,000.	
	9,847,742.			10,988,243.	2,720,447.	9,188,916.	
Capital Gains Tax @ 25% of Basis No.	-0-			11,249.	-0-	11,249.	
Total Tax	9,847,742.			10,999,494.	2,720,447.	9,200,165.	
Aggregate Consolidated Taxable Income of Companies having Taxable Income (Line 10, Rate Col. 4)	20,534,022.				30,561,350.	17,777,724.	
Percent of Item 2 of	100%.				63.08%	36.92%	
Total Consolidated Tax Allocated to Companies	9,847,742.				6,931,342.	2,916,400.	

(1) Capital Gains of United Gas Pipe Line Company Eliminated due to United Gas Corporation Capital Loss Carryover.
(2) Capital Gains of Unions Producing Company Eliminated due to United Gas Corporation Capital Loss Carryover
(3) For detail see page 2 attached
(4) Refund made in 1962 applicable to 1957 & Others

Schedule No. 3
Page 2 of 24

	Initial	Date
Prepared By		
Approved By		

United States Corporations and Subsidiaries
Computation of Consolidated and Separate Returns Basis
Federal Income Tax, Adjusted
Years 1957

	DIVIDENDS	(1) TOTAL Dividends Received	(2) Less Amount not out of Earnings & Profits	(3) Balance 100%	(4) 85%
1	United States Corporations				
2	United Gas Pipe Line Co.	56000000		56000000	47600000
3	Union Producing Co.	13900000	3446899	9531001	8101351
4	Total Intercompany	19000000	3446899	15553101	13220135
5					
6	Duval Sulphur & Potash Co.	933892		933892	793808
7					
8	Total Other	933892		933892	793808
9					
10	Total United Gas Corp.	19933892	3446899	16486992	14013943
11					
12	United Gas Pipe Line Company				
13	Southland Paper Mills, Inc.	3200000		3200000	2720000
14					
15	Total Dividends	19965892	3446899	16518992	14041943
16					
17					
18					
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	Initials	Date
Prepared By		
Approved By		

United Gas Corporation and Subsidiaries
Computation of Consolidated and Separate Returns Basis
Federal Income Tax Adjusted
Year 1958

	Consolidated Totals	Eliminations Debits	Eliminations Credits	Separate Returns Basis Total Separate Returns	United Gas Corporation	United Gas Pipe Line Company	Houston Lighting Company
Net Taxable Income (See Separate Agents' Report)					18093674	22048181	4966503
Adjustments:							
Houston Lighting Company - Gain on Retirement of Debt (Note 1)							(1362123)
Rate Refunds: Missouri Public Service Commission					(241467)		
Federal Power Commission					503734	(478763)(2)	
Contra					(164388)		
Taxable Income per Income Agents Report Adjusted					18071753	17569418	3604380
Taxable Income:							
United Gas Corporation	3604704	9966030					
United Gas Pipe Line Company	17778207	1447792(1)	18071753	18071753	18071753		
Houston Lighting Company	3604380		17569418	17569418		17569418	
Total	24987291	(48007)(1)	27000	27000		27000	3604380
		2009672	3604380	3604380			3604380
Less: Net Operating Loss Carryback		3541972	15492251(3)	4063553	1907173	1756380	399000
Total After Net Operating Loss Carryback				3604380			3604380
Less: 85% of Dividends				3704173	1907173	1783380	399000
Capital Gains				1329201	1329201	27000	273000
Capital Loss Carryback				192678	192678	148007	44671
Net Capital Gain				(148007)	(148007)		(148007)
Earned Taxable Income Excluding Dividends and Capital Gains	2481326			148007		148007	
2% @ 52% of Line 20	1290370			2556766	577555	1779211	
2% Additional Corporate Surtax	48601			1274796	330000	944796	
Less: $5,000 Surtax Credit	5000						
Capital Gains Tax @ 25% of Line 21	1284671			16000	5000	11000	
Total Tax				1258796	325000	933796	
Aggregate Consolidated Taxable Income of Companies	1284671			37000		37000	
Housing Taxable Income (Item 13)				1221796	325000	896796	
Percent of Line 28	2481326						
	(100.000%)			3604704	1777207	2430165	
Total Consolidated Taxable Income Allocated to Companies (Based on Line 29)				100.000%	49.301%	67.402%	
Transfers of Houston Lighting Company's Taxable Income to Affiliated Companies (Based on Line 30)	1284671			100.000%	49.301%	67.402%	
Total Consolidated Taxable Income Per Companies				1284671	633000	865671	1784342
	1284671						(1784342)
				1284671	633000	865671	
				2548470	1078207	1470329	

(1) Capital gains of United Gas Pipe Line Company eliminated in consolidation by United Gas Corporation.

(2) Capital gains of Houston Lighting & Power Company eliminated in consolidation by United Gas Corporation.

(3) See detail schedule attached.

(4) Repeal rate refunds for 1958 applicable to 1957 revenues.

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Schedule No. 9
Page 1 of 2

	Initials	Date
Prepared by		
Approved by		

United Gas Corporation and Subsidiaries
Computation of Consolidated and Separate Return Basis
Federal Income Taxes Adjusted
Year 1958

	Dividends	(1) Total Dividends Received	(2) Less Amount not out of Earnings & Profits	(3) Balance 100%	(4) 85%
1	United Gas Corporation:				
2	United Gas Pipe Line Co.	-		-	
3	Union Producing Company	17800000000	332097507	14477902493	12307717119
4					
5	Total Intercompany	17800000000	332097507	14477902493	12307717119
6					
7	Uneval Sulphur & Potash Co.	1147535 62		1147535 62	975405 28
8	Atlas Processing Co.	1250000		1250000	1062500
9					
10	Total Other	1160035 62		1160035 62	986030 28
11					
12	Total United Gas Corp.	18960035 62	332097507	15639060 55	13293201 47
13	United Gas Pipe Line Company				
14	Southland Paper Mills, Inc.	3200000		3200000	2720000
15					
16	Total Dividends	18992035 62	332097507	15671060 55	13320401 47

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	Initials	Date
Prepared By		
Approved By		

United Gas Corporation and Subsidiaries
Computation of Consolidated and Separate Return Basis
Federal Income Tax Adjustment
Year 1969

	Consolidated Totals	Eliminations Other Adjustments	Eliminations Dividends Adjustments	Total Separate Return Basis	Separate Return (Basis) United Gas Corporation	United Gas Pipe Line Company	Union Producing Company
Net Taxable Income (Per Revenue Agent's Report)					19880307	20977661	(1853746)
Adjustments:							
Union Producing Company - Net Operations Loss (Note)							1371880
Less Refunded: Municipal Public Service Commissions					(809518)		
Federal Power Commissions					599968	(396574)(2)	
To Customers					(324283)		
Taxable Income per Revenue Agent's Report Adjusted					19346474	20581087	(481866)
Taxable Income:							
United Gas Corporation	21315159	433852(1)	(2067767)	19364867	19364867		
United Gas Pipe Line Company	16980187		2077992	17262759		17081387	
Union Producing Company	(461866)			(461866)			(461866)
Total	18833480	433852	11633056(2)	29910848	19364867	17081387	(461866)
Less: 85% of Dividends	7368833			9514272	9514272	27200	
Capital Gains	173697			117540	44381	7048	16111
Revised Taxable Income Excluding Dividends and Capital Gains	11291450			20278197	9806214	16973139	(537477)
Tax @ 52% of Line 16	5871554			10805263	5099231	8824093	
Less: $600 Surtax Credit	55000			110000	55000	55000	
	5816554			10695263	5044231	8769093	
Capital Gains Tax @ 25% of Line 15	43424			29057	11095	17962	
Total Tax	5859978			10724320	5055326	8887055	
Aggregate Consolidated Taxable Income of Companies having taxable income (Line 19 plus Line 11)	19291346						
Percent of Line 23	100.00%						
Total Consolidated Tax - Allocated to Companies	5859978				21315159	16980187	
					11999%	88.001%	
					5055326	8887055	

Note:
(1) Exclusions from taxable income of debt retirement premium on redemption of United Gas Pipe Line Company bonds - applied in reduction of depreciable property bases.

(2) See detail on page 2 attached.

(3) Refunds made in 1967 applicable to 1969 disallowed

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Schedule No. 5
Page 2 of 2

	Initials	Date
Prepared By		
Approved By		

United Gas Corporation and Subsidiaries
Computation of Consolidated and Separate Returns Basis
Federal Income Tax, Adjusted
Year 1959

	Dividends	(1) Total Dividends Received	(2) Less Amount Not Out of Earnings & Profits	(3) Balance 100%	(4) 85%
1	United Gas Corporation				
2	United Gas Pipe Line Co.	-			
3	Union Producing Company	185000000	85561133 1	99438866 9	84523036 9
4					
5	Total Intercompany	185000000	85561133 1	99438866 9	84523036 9
6	Duval Sulphur & Potash Co.	12187500		12187500	10359375
7	Atlas Processing Co.	3062500		3062500	2603125
8					
9	Total Other	12493750 0		12493750 0	10619687 5
10					
11	Total United Gas Corp.	197493750 0	85561133 1	111932616 9	95142724 4
12					
13	United Gas Pipe Line Company				
14	Louisiana Paper Mills Inc	3200000		3200000	2720000
15					
16	Total Dividends	197813750 0	85561133 1	111225261 69	95414724 4
17					
18					
19					
20					
21					
22					
23					
24					
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Schedule No. 6
Page 1 of 2

Prepared By | Date
Approved By | Date

United Gas Corporation and Subsidiaries
Computation of Consolidated and Separate Returns Basis
Federal Income Tax Adjusted
Year 1962

	Consolidated Totals	Eliminations Other Adjustments	Eliminations Dividend Adjustments	Total Separate Returns Basis	Separate Returns Basis United Gas Corporation	Separate Returns Basis United Gas Pipe Line Company	Separate Returns Basis Union Producing Company
Net Taxable Income (Per Return)					11,327,741.	17,592,629.	(4,239,624).
Adjustments:							
Union Producing Company - Oil Operations Loss (Note)							2,801,292.
Rate Refunds: Mississippi Public Service Commission					(82,108).		
Federal Power Commission					45,450.	(4,171,784) (2)	
To Customers					(371,708).		
Prepaid Gas Cost						71,895.	
Taxable Income Per Return, Adjusted					10,919,375.	13,492,732.	(1,438,332).
Taxable Income							
United Gas Corporation	11,951,043	631,668 (1)	1,056,513 (3) & 1,081,013	11,174,842.	11,174,842.		
United Gas Pipe Line Company	14,184,503		277,200	14,184,703.		14,184,703.	
Union Producing Company	(1,438,332)			(1,438,332).			(1,438,332).
Total	14,697,214.	631,668	9,414,726 (3)	23,921,213.	11,174,842.	14,184,703.	(1,438,332).
Less: 95% of Dividends				7,968,128.	7,940,928.	27,200.	
Capital Gains	600,356 (4)			151,326.	82,188.	-	69,138.
Received Taxable Income Excluding Dividends and Capital Gains	14,622,260.			15,833,819.	3,151,726.	14,157,503.	(1,498,270).
Tax @ 52% of Line 17	7,603,575.			9,014,786.	1,638,897.	7,363,102.	
Less: $5,500 Surtax Credit	5,500.			5,500.	5,500.	5,500.	
	7,598,080.			8,661,786.	1,633,397.	7,357,602.	
Capital Gains Tax @ 25% of Line 16	150,089.			177,177.	177,177.	-	
Total Tax	7,748,169.			9,014,936.	1,810,574.	7,357,602.	
Aggregate Consolidated Taxable Income of Companies Having Taxable Income (Line 16 plus Line 18)	16,118,536.			195,023.	14,167,503.		
Percent of Line 21	100.000%			12.047%	87.896%		
Total Consolidated Tax Allocated to Companies	7,748,169.			2,414,488.	1,809,601.		

(1) Exclusion from taxable income of debt retirement increase on retirement of United Gas Pipe Line Company bonds applied to reduction of depreciable property basis.

(2) For detail see page 2 attached.

(3) Request made on 1961 applicable to 1962 returns.

(4) Capital Gains Separate Returns basis (Note 16)
USG&E Co. Capital loss - deductible as ordinary income in Separate Returns but offset against Capital gains in Consolidated returns
Sub-total
Capital Gains eliminated in Consolidations (Note 16 - See Next Page)
Capital Gains taxable in Consolidations

	131,312
	2,003
	133,315
	69,168
	600,356

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Schedule No. 6
Page 2 of 2

	Initials	Date
Prepared By		
Approved By		

United Gas Corporation and Subsidiaries
Computation of Consolidated and Separate Return Basis
Federal Income Tax, Adjusted
Years 1966

	Dividends	(1) Total Dividends Received	(2) Less Amount not due if Earnings Forfeit	(3) Balance 100%	(4) 85%
	United Gas Corporation				
	United Gas Pipeline Co.	-			
	Union Producing Co.	185000000	10408981 85	80910181 5	68773654 3
	Total Intercompany	185000000	10408981 85	80910181 5	68773654 3
	Duval Sulphur & Potash	1218750 00		1218750 00	1035937 50
	Atlas Processing Co.	3250000		3250000	2762500
	Total Other	1251250 00		1251250 00	1063562 50
	Total United Gas Corp.	1925125000	10408981 85	93426815	79409279 3
	United Gas Pipe Line Company				
	Smithland Paper Mills, Inc.	32000 00		32000 00	27200 00
	Total Dividends	1957325000	10408981 85	93742815	79681279 3

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Schedule No. 7.
Page 1 of 2

United Gas Corporation and Subsidiaries
Computation of Consolidated and Separate Returns Basis
Federal Income Tax Adjusted
Year 1961

	Consolidated Totals	Eliminations Affiliate Adjustments	Eliminations Dividend Adjustments	Total Separate Return Basis	United Gas Corporation	United Gas Pipe Line Company	Union Producing Company	United Gas Production Corporation
Net Taxable Income (Per Return)								
Adjustments:								
Union Producing Company (Oil Operations Only)								
United Gas Production Corporation								
Rate Refunds: Mississippi Public Service Commission								
Interest on Mississippi Public Service Commission Refund								
Federal Power Commission								
To Customers								
Prepaid Gas Cost								
Taxable Income Per Returns, Adjusted								
Taxable Income:								
United Gas Corporation								
United Gas Pipe Line Company								
Union Producing Company								
United Gas Production Corporation								
Total								
Less: Net Operating Loss Carryover								
Total after Net Operating Loss Carryover								
Less: 85% Dividends								
Capital Gains								
Revised Taxable Income Excluding Dividends and Capital Gains								
Tax @ 52% of Line 22								
7% Additional Corporate Income Tax								
Less: 85% Gross Income Credit								
Capital Gains Tax @ 25% of Line 21								
Total Tax								
Aggregate Consolidated Tax Allocable to Companies								
Having Taxable Income (Deficit Taxable Income)								
Percent of Line 30								
Total Consolidated Tax Allocable to Companies								
Transfer of Union Producing Company Net Deficit Carryover								
Total Consolidated Tax Payable								

Note:

(1) Payment of Mississippi Public Service Commission refunds previously collected under bond applicable to taxes as follows:

1958	$ 72,000
1959	88,000
1960	28,000
Total	$188,000

(2) Prepaid Gas Revenue:
Gross Revenue
Less 22½% Depletion
Net

(3) Dividends from Taxable Income of Affiliates not Consolidated

(4) Tax [illegible] per page 2 attached

(5) Represents Federal Income Tax applicable to rate refunds

(6) Capital gain changed to ordinary income. Property sold for fixed purposes only

(7) Tax rate is not applicable

Schedule No 7
Page 7 of

United States Corporation and Subsidiaries
Computation of Consolidated and Separate Returns Basis
Federal Income Tax, Adjusted
Years 1961

	Dividends	(1) Total Dividends Received	(2) Less Amount not Part of Taxable Income	(3) Balance 100%	(4) 85%
1	United States Corporation				
2	United States Pipe Line Co.	14 000 000 00		14 000 000 00	11 900 000 00
3	Union Producing Co.	4 500 000 00		4 500 000 00	3 825 000 00
4					
5	Total Intercompany	18 500 000 00		18 500 000 00	15 725 000 00
6	Duval Sulphur & Potash Co.	12 187 500 00		12 187 500 00	10 359 375 00
7	Atlas Processing Co.	3 250 000		3 250 000	2 762 500
8					
9	Total Others	12 512 500 00		12 512 500 00	10 635 625 00
10					
11	Total United States Corp.	19 751 250 00		19 751 250 00	16 788 562 50
12					
13	United States Pipe Line Company				
14	Smithland Paper Mills, Inc.	32 000 00		32 000 00	27 200 00
15					
16	Total Dividends	19 783 250 00		19 783 250 00	16 815 762 50
17					
18					
19					
20					
21					
22					
23					
24					
25	Note (7) Page 1 of Schedule No 7				
26					
27	Capital gains Separate Return Basis (Line 21)				171 614
28	Warren Producing Company - Capital gains Eliminated on Separate				
29	Return Basis by Net Operating Loss Carryover				140 094
30	Subtotal				311 708
31	Less: Capital gains eliminated in Consolidation (Line 17				
32	See Note (2))				76 917
33	Capital Gains taxable in Consolidation				234 791
34					
35					
36					
37					
38					
39					
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42					
43					

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Schedule No. 2

	Initials	Date
Prepared By		
Approved By		

UNITED GAS PIPE LINE COMPANY

INCOME AND DEDUCTIONS OF UNION PRODUCING COMPANY

APPLIED IN DETERMINATION OF TAXABLE INCOME AS SHOWN IN CONSOLIDATED FEDERAL INCOME TAX RETURN

SHOWING AMOUNTS ATTRIBUTABLE TO OIL AND TO GAS

1957

	Total Per Books	Oil	Gas	Basis of Assignment to Oil and to Gas
Operating Revenues	$ 55734032.88	22355571.84	33378461.12	Direct - Per Books
Operating Expenses	19190926.05	7463152.94	11727773.11	" " "
Depreciation and Depletion	6400000.00	—	—	Not used for tax purposes
Dry Holes	5212985.81	1963732.57	3249253.24	(A) Oil 37.67% Gas 62.33%
Unproven Leases - Abandoned	2894938.13	1128193.21	1766744.92	(B) Oil 37.67% Gas 62.33%
Taxes - Per Books	5177627.90	1971134.46	3206492.48	Direct - Per Books
Total Operating Revenue Deductions	39 876 524.87	14 526 253.18	25 350 271.69	" " "
Net Operating Revenue	16 857 508.01	7 829 318.66	9 028 189.43	" " "
Revenue from Lse. Other Phys. Prop.	208975.	82187.	126788.	(C) Oil 40.91% Gas 59.09%
Interest Revenues	190714.	78052.	112662.	(C) Oil 40.91% Gas 59.09%
Misl. Non-Operating Revenues	208097.	85091.	122906.	(C) Oil 40.91% Gas 59.09%
Non-Operating Revenue Deductions	676989.	(41535).	(635454).	(K) Oil 30.36% Gas 69.64%
Total Other Income	430202.	175815.	254387.	
Gross Income	17 287 710.01	8 005 133.66	9 282 576.43	
Interest Expense	2658190.	979011.	1679179.	(D) Oil 36.83% Gas 63.17%
Interest During Construction (Cr.)	(55799)	—	—	Not used for tax purposes
Miscellaneous Income Deductions	209787.	79761.	130026.	(E) Oil 38.02% Gas 61.98%
Total Income Deductions	2812178.	1058772.	1753406.	
Net Income Per Books	$ 14475532.			
Totals - Forwarded		$ 8890897.	$ 11311679.	

	Total	Oil	Gas	Basis of Assignment to Oil and to Gas
Forward		$ 8890897.	$ 11311679.	
TAX ADJUSTMENTS - PLUS				
Exc. of Pen. Explor. Exp. Over Allow.	121829.	45893.	75936.	(A) Oil 37.67% Gas 62.33%
Exc. of Lse. Aband'ts Over Allow.	5124536.	1930312.	3194224.	(B) " " "
Exc. of Dry Hole Costs Over Allow.	114518.	43139.	71379.	(B) " " "
Contributions Inallowable	209763.	209763.	—	
Depr. Charged Clearing Accts. on Bks.	233805.	70749.	163056.	(C) Oil 30.262 Gas 69.738
Net Adj. of Clearing Accts. - Per Bks.	154.	47	107	(C) " " "
Misel. Adjs. Various Exp. Unallowable	—	—	—	
Misel. Income Adjustments	408967.	167308.	241659.	(C) Oil 40.91% Gas 59.09%
Misel. Tax Ded. Adjs. - Net	(88802).	(33807).	(54995).	(E) Oil 38.07% Gas 61.93%
Gain on Property Sales - Net	—			
- - - - - - -	22222.	—	22222.	TAX RETURN - DIRECT
Sub-Total		696123.	859757.	
TAX ADJUSTMENTS - MINUS				
Depreciation for Tax Purposes	3157919.	1534710.	1623209.	Tax Return - Direct
Depletion for Tax Purposes	12633348.	5148846.	7483908.	" " "
Intangible Drilling Costs	5956149.	2693436.	3262713.	" " "
Amort. Past Serv. Pension Payments	22	11	11	(A) Oil 49.72% Gas 50.28%
Production Payments Adjustment	791208	323683	467525	(B) Oil 40.91% Gas 59.09%
Amort. Road Expense Adjustments	1875	778	1097	(D) Oil 36.83% Gas 63.17%
Delay Rentals - Capitalized on Bks.	1221246	460043	761203	(A) Oil 37.67% Gas 62.33%
Straight Line Amort.	20362	—	20362	TAX RETURN - DIRECT
Sub-Total		$ 10161021	$ 13614278	
Total		(7400)	(1463989)	
Taxable Income per Ret. (See P.S.C.)		(2037990)		
Oil		(7400)		
Gas		(1463989)		
Total		(2037990)		

Note: See Schedule 16 & 13 attached for derivation of percentages used for assignment to Oil and Gas

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Schedule No. 9

Prepared By		
Approved By		

UNITED GAS PIPE LINE COMPANY

INCOME AND DEDUCTIONS OF UNION PRODUCING COMPANY

APPLIED IN DETERMINATION OF TAXABLE INCOME AS SHOWN IN CONSOLIDATED FEDERAL INCOME TAX RETURN,

SHOWING AMOUNTS ATTRIBUTABLE TO OIL AND TO GAS

1952

		Total Per Books	Total Oil	Total Gas	Basis of Assignment to Oil and to Gas
1	Operating Revenues	$ [illegible]	[illegible]	[illegible]	Direct - Per Books
2					
3	Operating Expenses	[illegible]	[illegible]	[illegible]	" " "
4	Depreciation and Depletion	[illegible]	[illegible]	[illegible]	
5	Dry Holes	[illegible]	[illegible]	[illegible]	Not used for tax purposes
6	Unproven Leases - Abandoned	[illegible]	[illegible]	[illegible]	
7	Taxes	[illegible]	[illegible]	[illegible]	Direct - Per Books
8					
9	Total Operating Revenue Deductions	[illegible]	[illegible]	[illegible]	" " "
10					
11	Net Operating Revenue	[illegible]	[illegible]	[illegible]	" " "
12					
13	Revenue from Lse.-Other Phys. Prop.	[illegible]	[illegible]	[illegible]	
14					
15	Interest Revenues	[illegible]	[illegible]	[illegible]	
16					
17	Misc. Non-Operating Revenues	[illegible]	[illegible]	[illegible]	
18					
19	Non-Operating Revenue Deductions	[illegible]	[illegible]	[illegible]	
20					
21	Total Other Income	[illegible]	[illegible]	[illegible]	
22	Gross Income	[illegible]	[illegible]	[illegible]	
23					
24	Interest Expense	[illegible]	[illegible]	[illegible]	
25	Interest During Construction (Cr.)	[illegible]	—	—	Not used for tax purposes
26					
27	Miscellaneous Income Deductions	[illegible]	[illegible]	[illegible]	
28					
29	Total Income Deductions	[illegible]	[illegible]	[illegible]	
30					
31	Net Income Per Books	[illegible]			
32					
33	Totals - Forwarded		[illegible]	[illegible]	

		Total	Oil	Gas	Basis of Assignment to Oil and to Gas
	Forward		[illegible]	[illegible]	
	TAX ADJUSTMENTS - PLUS				
	Exc. of Pen Explor. Exp. Over Allow.	[illegible]	[illegible]	[illegible]	[illegible]
	Exc. of Lse. Aband'ts Over Allow.	[illegible]	[illegible]	[illegible]	(A) " " "
	Exc. of Dry Hole Costs Over Allow.	[illegible]	[illegible]	[illegible]	(A) " " "
	Contributions Unallowable	—			
	Depr. Charged Clearing Accts. on Rts.	[illegible]	[illegible]	[illegible]	[illegible]
	Net Adj. of Clearing Accts.-Per Rts.	[illegible]	[illegible]	[illegible]	[illegible]
	Misc. Adjs. Various Exp. Unallowable	[illegible]	[illegible]	[illegible]	[illegible]
	Misc. Income Adjustments	[illegible]	[illegible]	[illegible]	[illegible]
	Misc. Tax Exp. Adjs. - Net	[illegible]	[illegible]	[illegible]	[illegible]
	Gain on Property Sales:				
	Sale	[illegible]	[illegible]	—	Tax Return - Direct
	Sale	[illegible]	—	[illegible]	Tax Return - Direct
	R.A.R. Adjust.	[illegible]	[illegible]	[illegible]	Tax Return - Direct
	Misc. — R.A.R. Adjust.	[illegible]	[illegible]	[illegible]	(C) Oil 24.4% Gas 75.6%
	Sub-Total		[illegible]	[illegible]	
	TAX ADJUSTMENTS - MINUS				
	Depreciation for Tax Purposes	[illegible]	[illegible]	[illegible]	Tax Return - Direct
	Depletion for Tax Purposes	[illegible]	[illegible]	[illegible]	" " "
	Intangible Drilling Costs	[illegible]	[illegible]	[illegible]	" " "
	Amort. Past Serv. Pension Payments	[illegible]	[illegible]	[illegible]	[illegible]
	Production Payments Adjustment	[illegible]	[illegible]	[illegible]	[illegible]
	Amort. Bond Expense Adjustments	[illegible]	[illegible]	[illegible]	[illegible]
	Delay Rentals - Capitalized or Rts.	[illegible]	[illegible]	[illegible]	[illegible]
	[illegible]	[illegible]	[illegible]	[illegible]	TAX RETURN - DIRECT
	Sub-Total		[illegible]	[illegible]	
	Total		[illegible]	[illegible]	
	Taxable Income per Net (per Sch. 2)	[illegible]	[illegible]	[illegible]	
	Oil		[illegible]		
	Gas			[illegible]	
	Total	[illegible]			

Note. See Schedule No. 13 attached for calculations of percentages used for assignment to Oil and Gas

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Schedule No. 10

UNITED GAS PIPE LINE COMPANY

INCOME AND DEDUCTIONS OF UNION PRODUCING COMPANY

ALLOWED IN DETERMINATION OF TAXABLE INCOME AS SHOWN IN CONSOLIDATED FEDERAL INCOME TAX RETURN

SHOWING AMOUNTS ATTRIBUTABLE TO OIL AND TO GAS

For 1948

	Total Per Books	Total Oil	Total Gas	Basis of Assignment to Oil and to Gas
Operating Revenues	[illegible]	[illegible]	[illegible]	Direct - Per Books
Operating Expenses	[illegible]	[illegible]	[illegible]	" " "
Depreciation and Depletion	[illegible]	—	—	Not used for tax purposes
Dry Holes	[illegible]	[illegible]	[illegible]	(2) [illegible]
Unproven Leases - Abandoned	[illegible]	[illegible]	[illegible]	(3) [illegible]
Taxes	[illegible]	[illegible]	[illegible]	Direct - Per Books
Total Operating Revenue Deductions	[illegible]	[illegible]	[illegible]	" " "
Net Operating Revenue	[illegible]	[illegible]	[illegible]	" " "
Revenue from Lse.-Other Phys. Prop.	[illegible]	[illegible]	[illegible]	(4) [illegible]
Interest Revenues	[illegible]	[illegible]	[illegible]	(5) [illegible]
Misl. Non-Operating Revenues	[illegible]	[illegible]	[illegible]	(6) [illegible]
Non-Operating Revenue Deductions	[illegible]	[illegible]	[illegible]	(7) [illegible]
Total Other Income	[illegible]	[illegible]	[illegible]	
Gross Income	[illegible]	[illegible]	[illegible]	
Interest Expense	[illegible]	[illegible]	[illegible]	(8) [illegible]
Interest During Construction (Cr.)	[illegible]	—	—	Not used for tax purposes
Miscellaneous Income Deductions	[illegible]	[illegible]	[illegible]	(9) [illegible]
Total Income Deductions	[illegible]	[illegible]	[illegible]	
Net Income Per Books	[illegible]			
Totals - Forwarded		[illegible]	[illegible]	

Note: See Schedule No. 13 attached for derivation of percentages used for assignment to Oil and Gas.

	Total	Oil	Gas	Basis of Assignment to Oil and to Gas
Forward		6756617	13007389	
TAX ADJUSTMENTS - PLUS				
Exc. of Bad Debts Exp. Over Allow.	886421	220019	551537	(1) Col. 37.23% Line 42.77%
Exc. of Lse. Aband'ts Over Allow.	603343	171152	213041	(A)
Exc. of Dry Hole Costs Over Allow.	823202	110878	702414	(A)
Contributions Unallowable	117652	11741		
Depr. Charged Clearing Accts. on Rtn.	253701	72736	180965	(2) Col. 28.67% Line 71.33%
Net M.I. or Clearing Accts.-Per Rtn.	63145	15728	47417	(3) Col. 24.9% Line 75.1%
Misel. Adjs. Various Exp. Unallowable	—			
Misel. Income Adjustments	174776	45714	78714	(4) Col. 26.16% Line 73.84%
Misel. Tax Exp. Adjs. - Net	24453	7987	11511	(5) Col. 32.66% Line 67.34%
Gain on Property Sales - Misc.	624469		624469	Per Return - Misc.
Dollar	21524	7874	13650	(6) Col. 36.58% Line 63.42%
Office Supplies & Expenses - Misc.	17422	5022	12400	(7) Col. 28.82% Line 71.18%
Sub-Total		941434	1534734	
TAX ADJUSTMENTS - MINUS				
Depreciation for Tax Purposes	3667402	1495471	2173931	Tax Return - Direct
Depletion for Tax Purposes	13145969	5125254	8020715	" " "
Intangible Drilling Costs	5729673	1902883	3826790	" " "
Accrd. Past Serv. Pension Payments	—			
Production Payments Adjustment	836318	195085	230788	(8) Col. 46.3% Line 53.7%
Accrd. Bond Expense Adjustments	1605	711	894	(9) Col. 44.3% Line 55.7%
Delay Rentals - Capitalized on Rtn.	1700952	411823	1289129	(10) Col. 31.23% Line 68.77%
Intangibles Returned Direct	42521		42521	TAX RETURN - DIRECT
Sub-Total		9074732	14999484	
		(1371980)	(461326)	
Taxable Income per Ret. for Rate		(1371980)		
Oil		(461326)		
Gas		(1833306)		
Total				

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Schedule No. 11

UNITED GAS PIPE LINE COMPANY

INCOME AND DEDUCTIONS OF UNION PRODUCING COMPANY

APPLIED IN DETERMINATION OF TAXABLE INCOME AS SHOWN IN CONSOLIDATED FEDERAL INCOME TAX RETURN

SHOWING AMOUNTS ATTRIBUTABLE TO OIL AND TO GAS

1940

	Total Per Books	Total Oil	Total Gas	Basis of Assignment to Oil and to Gas
Operating Revenues	[illegible]	[illegible]	[illegible]	Direct - Per Books
Operating Expenses	[illegible]	[illegible]	[illegible]	" " "
Depreciation and Depletion	[illegible]	[illegible]	[illegible]	Not used for tax purposes
Dry Holes	[illegible]	[illegible]	[illegible]	(B) Oil 39.42% Gas 60.58%
Improven Leases - Abandoned	[illegible]	[illegible]	[illegible]	(B) Oil 39.42% Gas 60.58%
Taxes	[illegible]	[illegible]	[illegible]	Direct - Per Books
Total Operating Revenue Deductions	[illegible]	[illegible]	[illegible]	" " "
Net Operating Revenue	[illegible]	[illegible]	[illegible]	" " "
Revenue from Lse.-Other Phys. Prop.	[illegible]	[illegible]	[illegible]	(B) Oil 37.67% Gas 62.33%
Interest Revenues	[illegible]	[illegible]	[illegible]	(B) Oil 37.67% Gas 62.33%
Misc. Non-Operating Revenues	[illegible]	[illegible]	[illegible]	(B) Oil 37.67% Gas 62.33%
Non-Operating Revenue Deductions	[illegible]	[illegible]	[illegible]	(C) Oil 27.03% Gas 72.97%
Total Other Income	[illegible]	[illegible]	[illegible]	
Gross Income	[illegible]	[illegible]	[illegible]	
Interest Expense	[illegible]	[illegible]	[illegible]	(D) Oil 37.57% Gas 62.43%
Interest During Constpuction (Cr.)	[illegible]	[illegible]	[illegible]	Not used for tax purposes
Miscellaneous Income Deductions	[illegible]	[illegible]	[illegible]	Contributing Oil 27.03% Gas 72.97%
Total Income Deductions	[illegible]	[illegible]	[illegible]	
Net Income Per Books	[illegible]			
Totals - Forwarded		[illegible]	[illegible]	

Note: See Schedule No. 12 attached for derivation of percentages used for assignment to Oil and Gas.

	Total	Oil	Gas	Basis of Assignment to Oil and to Gas
Forward		[illegible]	[illegible]	
TAX ADJUSTMENTS - PLUS				
Exc. of Gen. Depler. Exp. Over Allow.	(1185996.)	(711598.)	(474398.)	(C) Oil 39.42% Gas 60.58%
Exp. of Lse. Aband'ts Over Allow.	490413.	294248.	196165.	(A) " "
Exc. of Dry Hole Costs Over Allow.	1324434.	794660.	529774.	(A) " "
Contributions Unallowable	81080.	81080.		
Depr. Charged Clearing Accts. on Exs.	311772.	99990.	211782.	(C) Oil 27.03% Gas 72.97%
Net Adj. of Clearing Accts. - Per Exs.	140720.	19432.	50814.	(C) Oil 27.03% Gas 72.97%
Misc. Adjs. Various Exp. Unallowable	(91570.)	(24734.)	(66836.)	(C) " "
Misc. Income Adjustments	121459.	51455.	69504.	(B) Oil 37.57% Gas 62.43%
Misc. Tax Exp. Adjs. - Net	77305.	1552.	75753.	(C) Oil 27.03% Gas 72.97%
Gain on Property Sales - Net	47138.	-	47138.	Tax Returns Direct
Sub-total		811452.	1522154.	
TAX ADJUSTMENTS - MINUS				
Depreciation for Tax Purposes	4570479.	1990978.	2579501.	Tax Return - Direct
Depletion for Tax Purposes	1240324.	482477.	757847.	" " "
Intangible Drilling Costs	1534528.	571993.	962535.	" " "
Amort. Past Serv. Pension Payments				
Production Payments Adjustment				
Amort. Bond Expense Adjustments	1895.	711	1184	(D) Oil 37.57% Gas 62.43%
Delay Rentals - Capitalized on Exs.	1442374.	571884.	870490	(A) Oil 39.65% Gas 60.35%
Transfer Between Accts.	45492.		45492.	Tax Return - Direct
Advance Royalty Bonus Exhaustive	421295.	403554.	217741.	Tax Returns - Direct
Sub-Total		1028179.	1524079.	
Total		782392.	1452237.	
Taxable Income per Ret. (or E.A.R.)	4237284.			
Oil	2782392.			
Gas	(1452237.)			
Total	4237284.			

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Schedule No. 12

UNITED GAS PIPE LINE COMPANY
INCOME AND DEDUCTIONS OF UNION PRODUCING COMPANY
APPLIED IN DETERMINATION OF TAXABLE INCOME AS SHOWN IN CONSOLIDATED FEDERAL INCOME TAX RETURN
SHOWING AMOUNTS ATTRIBUTABLE TO OIL AND TO GAS
1961

	Total Per Books	Total Oil	Total Gas	Basis of Assignment to Oil and to Gas
Operating Revenues	62,69[illegible]	[illegible]	32,53[illegible]	Direct
Operating Expenses	18,42[illegible]	6,47[illegible]	11,94[illegible]	"
Depreciation and Depletion	7,92[illegible]	[illegible]	[illegible]	Not used for tax purposes
Dry Holes	2,01[illegible]	90[illegible]	1,10[illegible]	(a)
Unproven Leases - Abandoned	4,27[illegible]	1,76[illegible]	2,51[illegible]	(a)
Taxes	5,05[illegible]	1,72[illegible]	3,32[illegible]	Direct - Per Books
Total Operating Revenue Deductions	37,88[illegible]	10,85[illegible]	19,17[illegible]	" " "
Net Operating Revenue	24,80[illegible]	9,21[illegible]	14,58[illegible]	" " "
Revenue from Lse.-Other Phys. Prop.	196[illegible]	78[illegible]	1,20[illegible]	(a) 37.27% - 62.73%
Interest Revenues	988[illegible]	37[illegible]	[illegible]	(a)
Misc'l. Non-Operating Revenues	1,09[illegible]	90[illegible]	87[illegible]	(b)
Non-Operating Revenue Deductions	-	-	-	(c)
Total Other Income	2,28[illegible]	1,12[illegible]	2,70[illegible]	
Gross Income	25,04[illegible]	9,33[illegible]	14,56[illegible]	
Interest Expense	2,60[illegible]	82[illegible]	1,51[illegible]	(a) 37.27% - 62.73%
Interest During Construction (Cr.)	46[illegible]			Not used for tax purposes
Miscellaneous Income Deductions	98[illegible]	37[illegible]	[illegible]	Direct - Per Books adj. 37.27% - 62.73%
Total Income Deductions	2,19[illegible]	92[illegible]	1,31[illegible]	
Net Income Per Books	12,85[illegible]			
Totals - Forwarded		9,46[illegible]	13,23[illegible]	

Note: See Schedule No. 13 attached for derivation of percentages used for assignment to Oil and Gas.

	Total	Oil	Gas	Basis of Assignment to Oil and to Gas
Forward		9,46[illegible]	13,23[illegible]	
TAX ADJUSTMENTS - PLUS				
Exc. of Obn.Depletion,Dry,Dpr.Over Allow.	34[illegible]	14[illegible]	20[illegible]	(a) 37.27% - 62.73%
Exc. of Lse. Aband'ts Over Allow.	76[illegible]	28[illegible]	44[illegible]	(a) " " "
Exc. of Dry Hole Contd Over Allow.	[illegible]	17[illegible]	09[illegible]	(a) " " "
Contributions Deductible	93	93	-	
Depr.Charged Clearing Accts.on Exs.	46[illegible]	17[illegible]	29[illegible]	(a) " " "
Net Adj.of Clearing Accts.-Per Exs.	118	53	65	(a) " " "
Misc'l.Adjs.Various Pay.Unallowable	+			
Misc'l. Income Adjustments	263	79	184	(a) " " "
Misc'l. Tax Exp.Adjs. - Net	(372)	(171)	(201)	(a) " " "
Gain on Property Sales				
	+	+	+	
	140	-	140	Tax Return - Direct
Sub-total		85	13	
TAX ADJUSTMENTS - MINUS				
Depreciation for Tax Purposes	432	172	260	Tax Return - Direct
Depletion for Tax Purposes	13[illegible]	5[illegible]	7[illegible]	" " "
Intangible Drilling Costs	415	148	266	" " "
Amort. Past Serv. Pension Payments	(1		(1	(a) 37.27% - 62.73%
Production Payments Adjustment	72	27	45	(a) " " "
Amort. Bond Expense Adjustments	1		1	(a) " " "
Delay Rentals - Capitalized on Exs.	12[illegible]	5[illegible]	7[illegible]	(a) " " "
Excess Book Retirement Accts.	98	-	98	Tax Return - Direct
Sub-Total		9[illegible]	13[illegible]	
Total		(7[illegible]	6[illegible]	
Taxable Income per Ret. (or R.A.R.):	(66			
Oil	(9[illegible]			
Gas	6[illegible]			
Total	(66			

Schedule No. 13

	Checked	Date
Prepared by		
Examined by		

United Gas Pipe Line Company

Explanation of derivation of percentages used for assignment to Oil and to Gas

(A) Ratio of Unions applications and development costs to Oil and to gas for respective years

(B) Ratio of Unions gross operating revenues from oil and from gas as shown in Federal income tax returns for respective years

(C) Ratio of Unions operating expenses to oil and to gas per books, adjusted to tax basis per Federal income tax returns for respective years

(D) Ratio of Unions net plant to oil and to gas for respective years

(E) Ratio of Unions taxes to oil and to gas per books for respective years

(F) Ratio of each years current pension expense to oil and to gas per books for respective years

Exhibit

United Gas Pipe Line Company Exhibit 14-6 — Summary of Tax Effects of 1962 Rate Refund applied to years in which affected revenues were received as compared with tax effect arising from rate income reduction in 1962.

FPC Docket No. RP64
Exhibit No. ——
Witness: W.B. Moore

	Initials	Date
Prepared By		
Approved By		

United Gas Pipe Line Company

Summary of Tax Effects of 1962 Rate Refund applied to years in which the affected revenues were received as compared with Tax Effects arising from rate refund deduction in 1962

	(1)	(2) Tax Liability Allocated to Pre-Refund Period	(3) Tax Liability Allocated to U.G.P.L. Co. Refund	(4) Difference
1956 - R.A.R.		$ 11710 900	$ 9899795	$ 2811105
1957 R.A.R.		12249608	8079975	4170528
1958 R.A.R.		13999756	11392398	2607358
1959 R.A.R.		9778220	7796350	2021870
1960 Refund		7164820	5082782	2081738
1961 Refund		7998911	5883288	2115623
				$ 15836722
1962 Estimated Tax Liability of U.G.P.L. Co. on Consolidated return basis before giving effect to the rate reduced deduction				7665665
U.G.P.L. Co's portion of Consolidated Tax Liability for 1962 before giving effect to the Consolidated loss carryback arising in 1962 as a result of the rate reduced deduction			$ 9978 770	
Reimbursement of 1962 Consolidated Tax liability after giving effect to the loss carry-back deduction for U.G.P.L. Co's portion of such reduced tax liability			6177 785	
Refund to be received by U.G.P.L. Co.				$ 3796 485
Total Reduction of Refund to be to U.G.P.L. Co. as a result of rate reduced deduction				$ 19463 207

Memphis Light, Gas and Water Division Exhibit 36 (Revised) Summary of taxable income (or loss) in consolidation, United and subsidiaries, years 1957 through 1961, inclusive.

Exhibit 36 (Revised) 1/

UNITED GAS PIPE LINE CO.
Docket No. RP63-1

Summary of Taxable Income or (Loss) in Consolidation
United Gas Corporation and Subsidiaries
Years 1957-1961, Inclusive

Line No.		Amount
	1957	
1	United Gas Corp.	$ 2,743,517
2	United Gas Pipe Line Co.	25,615,779
3	Union Producing Co.	(2,269,975)
4	Consolidated Taxable Net Income	26,089,321
	1958	
5	United Gas Corp.	3,528,821
6	United Gas Pipe Line Co.	22,573,974
7	Union Producing Co.	4,852,736
8	Consolidated Taxable Net Income	30,955,531
	1959	
9	United Gas Corp.	2,939,594
10	United Gas Pipe Line Co.	20,943,401
11	Union Producing Co.	(1,958,398)
12	Consolidated Taxable Net Income	21,924,598
	1960	
13	United Gas Corp.	2,700,979
14	United Gas Pipe Line Co.	17,569,439
15	Union Producing Co.	(4,333,704)
16	Consolidated Taxable Net Income	15,936,714
	1961	
17	United Gas Corp.	(2,888,741)
18	United Gas Pipe Line Co.	18,588,390
19	Union Producing Co.	(160,285)
20	United Overseas	(24,354)
21	Consolidated Taxable Net Income	15,515,010
	1957-1961, Inclusive	
22	United Gas Corp.	9,024,170
23	United Gas Pipe Line Co.	105,290,983
24	Union Producing Co.	(3,869,626)
25	United Overseas	(24,354)
26	Consolidated Taxable Net Income	110,421,173

7116-7118 FPC Order providing for hearing suspending proposed revised tariff sheets and fixing date of hearing issued 7-27-62.

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Joseph C. Swidler, Chairman; Howard Morgan, L. J. O'Connor, Jr., Charles R. Ross and Harold C. Woodward.

United Gas Pipe Line Company) Docket No. RP63-1

ORDER PROVIDING FOR HEARING, SUSPENDING PROPOSED REVISED TARIFF SHEETS, AND FIXING DATE OF HEARING

(Issued July 27, 1962)

United Gas Pipe Line Company (United) on June 15, 1962, tendered for filing certain revised tariff sheets 1/ to be included in its FPC Gas Tariff, First Revised Volume No. 1, proposed to become effective on August 1, 1962 2/, and providing for an annual increase in its rates and charges of $5,600,000 or four percent, to its jurisdictional customers, based upon sales for the year ended March 31, 1962, as adjusted. 3/ The supporting statements accompanying the tendered filings are prepared in the form of exhibits and prepared testimony in substantial compliance with the Commission's proposed regulations which are now under consideration in Docket No. R-207 as issued February 20, 1962.

1/ The tendered filing includes:
First Revised Sheets Nos. 5, 7, 50, 67, 75, and 84.
Second Revised Sheet No. 3.
Fourth Revised Sheet No. 99.
Fifth Revised Sheets Nos. 1, and 102.
Sixth Revised Sheets Nos. 34, 35, 44, and 45.
Seventh Revised Sheets Nos. 103, and 104.
Eighth Revised Sheets Nos. 4, 6, 10, 12, 16, 18, 21, 23, 25, 27, 28, 30, 32, and 100.
Ninth Revised Sheet No. 101.

2/ The settlement agreement approved by Commission order issued March 1 1962, provides for a continuation of proposed rates in Docket No. RP61-18 until December 31, 1962, subject to certain audit and refund procedures. United indicates it will move in this proceeding to make the proposed increased rates effective on January 1, 1962, if the Commission suspends them for the full five months statutory period from August 1, 1962.

3/ The increased rates and charges proposed herein would be in addition to the increased rates and charges subject to audit and refund in Docket No. RP61-18.

DC 30

In support of its proposed increased rates and charges, United primarily relies upon claimed increases in the cost of purchased gas due to shifts in sources of supply to higher priced gas and increased rates of its existing suppliers, increased costs due to new facilities, and lower sales due to the loss of load in San Antonio, Texas. United claims the need for a 6.5% rate of return on its own rate base, and claims need for 11% rate of return on the rate base of its affiliate, Union Producing Company (Union), whose costs are shown in support of the contract prices included in United's cost of purchased gas. In addition, United computes its Federal income tax liability using a 52% rate without reflecting the lower consolidated effective tax rate paid by United's parent company, United Gas Corporation.

United has not fully supported its proposed increased rates and charges in several respects, including, but not limited to, cost of purchased gas, estimated sales volumes associated with new facilities, rate of return, Federal income taxes, the utilization of a zone-by-zone method of allocation of costs, and in the level of the demand-commodity components of the proposed rates and charges. 4/ Furthermore, a number of United's supplier's rates are presently being collected by those suppliers subject to refund. Some of these supplier proceedings have been the subject of settlement negotiations resulting in rate reduction and refund agreements which have recently been approved or submitted to the Commission for its approval. 5/ In addition, proceedings involving Union's rates in Docket Nos. G-13811, et al., are now before the Commission, the Presiding Examiner having issued a decision therein on June 26, 1962. These supplier proceedings involve, in the aggregate, a possibly larger reduction in United's purchase gas costs than the amount of the rate increase filed for by United herein.

The increased rates and charges and the changes in tariff form and rate design contained in the revised tariff sheets tendered for filing on June 15, 1962, as aforementioned, have not been shown to be justified, and may be unjust, unreasonable, unduly discriminatory, preferential, or otherwise unlawful.

4/ Willmut Gas and Oil Company v. F.P.C., 297 F. 2d 112.

5/ Tidewater Oil Company, et al., Docket Nos. G-13310, et al., order approving general rate settlement, issued June 15, 1962, as modified by order issued July 11, 1962; The Ohio Oil Company, Docket Nos. RI60-92, et al., issued June 28, 1962; Shell Oil Company, Docket Nos. G-13397, et al., settlement agreement certified by Presiding Examiner to Commission on June 19, 1962.

The Commission finds:

It is necessary and proper in the public interest and to aid in the enforcement of the provisions of the Natural Gas Act, that the Commission enter upon a public hearing concerning the lawfulness of the rates, charges, classifications, and services contained in United's FPC Gas Tariff, First Revised Volume No. 1, as proposed to be amended by the revised tariff sheets tendered for filing on June 15, 1962, and that said revised tariff sheets and the rates contained therein be suspended and the use thereof deferred as hereinafter provided.

The Commission orders:

(A) Pursuant to the authority of the Natural Gas Act, particularly Sections 4 and 15 thereof, the Commission's Rules of Practice and Procedure and the Regulations under the Natural Gas Act [18 CFR, Chapter I], a public hearing be held pursuant to the procedures to be prescribed by further order, concerning the lawfulness of the rates, charges, classifications, and services contained in United's FPC Gas Tariff, as proposed to be amended by the aforementioned revised tariff sheets tendered for filing on June 15, 1962.

(B) Pending such hearing and decision thereon, United's revised tariff sheets, as tendered for filing on June 15, 1962, and the rates and charges contained therein, are hereby suspended and the use thereof deferred until January 1, 1963, and until such further time as they may be made effective in the manner prescribed by the Natural Gas Act.

(C) Notices and petitions to intervene may be filed with the Federal Power Commission, Washington 25, D.C., in accordance with the Commission's Rules of Practice and Procedure, Sections 1.8 and 1.37 (f) [18 CFR 1.8 and 1.37 (f)] on or before August 20, 1962.

By the Commission.

Joseph H. Gutride,
Secretary.

Effective Tax Rate

United's cost of service includes Federal income taxes in the amount of $12,099,662 calculated at the statutory 52% rate. Staff proposes that the Federal income tax component be reduced to $6,655,871 based on a consolidated effective tax rate for the tax year of 46.82% plus investment credit deductions. Memphis suggests a further reduction of such allowance to $3,923,208, or under certain alternative theories, to zero.

United Gas Corporation, together with its wholly-owned subsidiaries, United, Union, and Overseas, files a consolidated income tax return, as is its privilege under Section 1501 of the Internal Revenue Code of 1954, in lieu of separate returns for each company. Union had $8,722,362 of gross tax losses between 1957 and 1961 (Exh. 36, rev.) and a net total tax loss during this period of $3,869,326. This tax loss resulted from Union's use of the statutory percentage depletion allowance resulting from the exploration, development, and operation of its oil and gas properties. Union is not a regulated public utility within the meaning of the Federal income tax law (Tr. 490) and its sales of oil and other related products are unregulated and outside the jurisdiction of the Commission.

The effect of the consolidated income tax return during the years in which Union has a tax loss is to reduce the total income tax liability of all the affiliated companies, including United, below the total of what they would pay on a separate return basis. Staff and Memphis take the position that all of the affiliates should be treated as a single entity and the lower effective tax rate resulting from the consolidated return should be applied in computing the amount of Federal income taxes includible in United's cost of service.

United insists that it is entitled to apply the statutory 52% income tax rate unreduced by the utilization in the consolidated return of deductions and losses attributable to the unregulated, non-jurisdictional, and non-utility operations of affiliates. Losses resulting from unregulated, non-jurisdictional oil operations in particular should not be considered for rate-making purposes. Staff believes United is entitled to share equitably in the consolidated tax return savings produced by Union's tax losses on the ground that Union is United's integrated production arm and recovers its exploration and development costs through prices it charges its customers -- prices ultimately borne by United's customers. Staff also relies on the doctrine of "taxes actually paid" 9/. United contends that its customers bore none of the expenses of Union's non-utility operations and are not entitled to have their rates reduced by virtue of Union's losses.

As noted by United, (Br. p. 53) the issue here is essentially the same as that now pending before the Commission in the matter of Cities Service Gas Co., Docket No. 18799, on exception from Examiner Kelly s

9/ Citing El Paso Natural Gas Co. v. FPC, 281 F.2d 567 (1960) and similar cases.

decision dated April 23, 1962. There the Examiner allowed City Service to compute its Federal income tax component at the statutory 52% rate on the ground that the actual taxes paid doctrine, which requires any tax savings to be passed on to the consuming public, applies only to tax savings related to and derived from the regulated companies' jurisdictional gas business. Examiner Kelly's conclusions were concurred in approximately one month later on May 28, 1962, when Examiner Zwerdling in Tennessee Gas Transmission Co., Docket No. G-19983, rejected the consolidated effective tax rate proposed by the Staff 10/ which would have resulted in a lower tax rate through the utilization of losses incurred by non-utility and Canadian oil operations. The Tennessee Gas case has now been settled but the Cities Service case is pending before the Commission for decision.

The reasoning of the Examiner in both the Cities Service and Tennessee Gas decisions is persuasive and compels rejection of the Staff position that the income tax component should be reduced from 52% to the consolidated effective tax rate of 46.82% without regard to the character and source of the tax losses giving rise to the tax savings. The El Paso decision does not deal with the specific issue presented here -- whether it is proper to reduce gas rates by utilizing tax losses applicable to unrelated non-utility operations. It does not follow, however, that the 52% statutory rate must be applied. United needs Union's losses to achieve any saving through the consolidated return. Conversely, the loss company needs United's profits to achieve a tax saving for the consolidated group. The necessity of a joint effort suggests the desirability of a division of the tax savings effected.

An effective tax rate of 49.51% produces an equitable division of the tax savings between the profit and loss companies involved in this proceeding. This rate is derived as follows:

First, we determine the total amount of taxable income for all companies in the consolidation having taxable income for the test year. The

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10/ Staff's initial brief does not make reference to either Cities Service or Tennessee Gas. Its reply brief contains the following reference:

> United cites the Examiner's decisions in the Cities Service and Tennessee Gas cases as authority for its position on the consolidated effective tax rate issue. We point out, however, that there was a contrary Examiner's decision in the Northern Natural case which it has been unable to distinguish and that this issue is presently before the Commission for decision (p. 31).

effect of this is to ignore the "loss" companies since they pay no tax. The total amount of taxable income of the "profit" companies is $122,056,630 for the 1957-61 period as derived from Appendix A-1 A/ of the Memphis brief. We use an average of taxable income for five years from 1957 to 1961, in determining the effective tax rate in order to avoid the distortion that might result from the use of a single year.

We then apply the 52% statutory tax rate to the total amount of taxable income to arrive at the total tax liability. The same result would be accomplished if these companies having taxable income had filed separate returns and paid their taxes on the basis of the 52% rate. In the instant case, the application of the 52% rate to $122,056,630 results in an income tax liability of $63,469,447 which, of course, relates to the "profit" companies, or those having taxable income during the test year.

We then deduct the amount of the Federal income tax paid in filing the consolidated return, from the amount of the tax liability determined on the separate return basis. The difference thus derived represents the amount of the tax saving resulting from the filing of the consolidated return. In the case at hand, the amount of $57,386,940, representing the consolidated tax payment for the period 1957-61, is deducted from the amount of $63,469,447 representing the tax determined on a separate return basis for the "profit" companies, to arrive at the amount of $6,082,507 representing the tax saving.

Finally, we divide the tax savings. This is accomplished by first multiplying the tax saving of $6,082,507 by 50%, and then dividing the resultant figure of $3,041,253 by the amount of the tax figured on a separate return basis of $63,469,447, thereby arriving at a percentage of 4.7917. The 4.7917% is multiplied by 52% to arrive at another percentage of 2.492. This percentage of 2.492 is then deducted from the 52% statutory rate to arrive at 49.51% as the effective tax rate for application to the taxable income of United.

The dollar effect of an effective tax rate of 49.51% is shown by its application to the net taxable income of United presented in the exhibits of United, Memphis, Interveners, and Staff B/. The resultant tax liability for United is reduced to $11,520,011, as compared with United's proposed tax liability of $12,099,662, or a reduction of $579,651; increased to $4,022,543, compared with $3,923,208, proposed by Memphis, an increase of $99,335; increased to $5,886,718 as compared with $5,452,481 proposed by Staff, an increase of $434,237.

9113-9166 Excerpts from Opinion No. 428 and Order determining rates and providing for refunds issued May 14, 1964.

9113-9150 From Majority Decision by Black, Commissioner.

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Joseph C. Swidler, Chairman; L. J. O'Connor, Jr., Charles R. Ross, Harold C. Woodward and David S. Black.

United Gas Pipe Line Company Docket No. RP63-1

OPINION NO. 428

OPINION AND ORDER DETERMINING RATES AND PROVIDING FOR REFUNDS

(Issued May 14, 1964)

BLACK, Commissioner:

This proceeding arises under Section 4(e) of the Natural Gas Act upon a filing by the United Gas Pipe Line Company on June 15, 1962, seeking an annual increase in the rates and charges to United's jurisdictional customers of approximately $5,600,000, to be effective August 1, 1962. The United Gas Pipe Line Company is a large pipeline system operating in Texas, Louisiana, Mississippi, Alabama and Florida. (See map, Appendix 1). It purchases gas from producers including its affiliate Union Producing Company and sells gas for direct consumption by industrial customers and for resale by towns, distribution systems and pipelines which in turn transport gas to the mid-continent and the eastern seaboard. Both United and Union are owned entirely by United Gas Corporation which also operates distribution systems in Texas, Louisiana and Mississippi. Events subsequent to United's filing, primarily producer rate reductions, so reduced United's jurisdictional costs that the jurisdictional increase became a net rate increase of only $1,600,000 as of January 1, 1963. 1/

By Commission order of July 27, 1962, the proposed increased rates were suspended until January 1, 1963, on which date they became effective, 2/ subject to refund of all amounts collected above those found to be just and reasonable in this proceeding. The hearing commenced on November 27, 1962, after service of the direct case in chief and exchange of proposed testimony and exhibits pursuant to the expedited hearings procedure

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1/ Since the close of the record there have been further producer rate reductions so that the jurisdictional increase of $1,600,000 would become a $600,000 net decrease as of August 30, 1963.

2/ On December 19, 1962, United filed substitute rates to reflect the reduction in its costs which had occurred and these were permitted to become effective January 1, 1963, by Commission order of January 17, 1963.

prescribed by the Commission on August 6, 1962 (28 FPC 295). 3/ The examiner's decision was issued on June 17, 1963, and upon request of the parties in their exceptions thereto, 4/ oral argument was held before the Commission on September 20, 1963. The proceedings, involving numerous issues, are now before us on these exceptions to the examiner's decision.

On some of the issues there is no dispute. One of these is the rate of return on which United presented evidence, but the staff, United and all participants stipulated 6.5 percent as the fair rate of return. Other matters not in dispute are depreciation and taxes other than income tax. Included in the cost of purchased gas are payments under rates which are subject to Commission proceedings; United therefore agrees that the rates determined in this proceeding will be subject to adjustment to reflect final determination of any such conditionally effective gas purchase prices included in the cost of service. The remaining issues relating to (1) the test period, (2) the cost of service including the cost of purchased gas, federal income taxes, the amount of prepaid gas in the rate base, (3) allocation of costs, and (4) the design of rates, are strongly contested by the parties. Also certain interveners contend that the expedited hearing procedures have substantially deprived them of their rights to due process. Included within the issue pertinent to federal income taxes was a question of far reaching significance to the natural-gas and electric utility industries as a whole, the proper treatment for rate making purposes of the investment tax credit authorized by the Internal Revenue Act of 1962. However, subsequent to the argument of this case Congress has prescribed that such investment tax credits shall not be used to reduce the pipeline's federal income taxes for the purpose of establishing the cost of service without the consent of the company. Therefore this is no longer an issue in the case.

TEST PERIOD

United filed its rate increase on June 15, 1962, with a base period of 12 months ending March 31, 1962, with adjustments for newly constructed facilities to go into service before November 30, 1962. United contends,

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3/ The order of August 6, 1962 directed United to serve its direct case in chief by August 21, 1963, interveners and staff to serve their proposed testimony and exhibits by October 1, 1962, and that a pre-hearing conference be held on October 22, 1962. These dates were complied with by the parties. The pre-hearing conference set November 19, 1962, as the date for filing of United's rebuttal case. The hearing lasted from November 27, 1962 through January 28, 1963. Briefs and reply briefs were thereafter exchanged.

4/ Mississippi River Fuel Corporation, Mississippi Valley Gas Company, United Gas Pipe Line Company (7/5/63); Texas Eastern Transmission Corporation, Southern Natural Gas Company, Commission staff, Memphis Light, Gas and Water Division, Willmut Gas and Oil Company, Laclede Gas Company, Texas Gas Transmission Corporation and Louisville Gas and Electric Company, Western Kentucky Gas Company, Public Service Electric and Gas Company, et al. (Eastern Intervenors), Natural Gas Pipeline Company of America (7/8/63); Southern Union Gas Company, Tyler Gas Service Company (7/9/63)

and the examiner agrees that this is in compliance with Section 154.63(e)(2)(1) of the Commission's regulations, which provide in part as follows:

> ". . . based upon a test period which shall consist of a base period of 12 consecutive months of most recently available actual experience, adjusted for changes in revenues and costs which are known and are measurable with reasonable accuracy at the time of the filing, and which will become effective within nine months after the last month of available actual experience utilized in the filing, but in no event shall such test period extend six months beyond the date of filing."

Staff, however, argues that rates for the future are not set for a single year but for a future period of indeterminate duration upon the basis of normalized conditions. Thus staff contends that we should make adjustments to the test year sales presented by United so that we would reflect the revenue increase experienced by the company as a result of its investment in new facilities put in service April 1, 1961 through November 30, 1962, and included in the test year rate base. For this purpose the staff adopted an estimate of 1963 sales presented by United. On the other hand United argues that staff use of estimated 1963 sales has the same effect as if staff were to use an estimated 1963 test year in violation of the Commission's historic policy requiring filing data based on a test period of the latest 12 months of actual experience adjusted for known changes occurring within a stated period.

Of course, it is common in rate cases to adjust cost of service items, particularly items of expense, where a change has been made after the end of the test year. In the present case the situation is peculiar, and something more than the usual adjustment is required. United's claimed rate base includes $56,248,618 of newly certificated gas facilities which were not in service throughout the base period, but were scheduled to become operative on or before November 30, 1962. These facilities include the important new line from southern Louisiana to Sterlington in northern Louisiana. Costs associated with the new facilities include depreciation, return, and state and federal taxes. The record shows that these new facilities would be used for sales made after the proposed rates took effect on January 1, 1963. In supporting its proposed rates for a future period it was proper for United to include these facilities, for if it had confined its presentation to an average of net plant in existence during the period ending March 31, 1962, the cost results would not have been representative of the future period when the rates would be in effect. By the same token the staff was also proper in contending that 1963 sales should be taken into account instead of the test year sales presented by United. The 1963 sales amount to 1,343,703,213 Mcf at 14.9 psia, as shown by United in its rebuttal case and as adopted by the staff. Furthermore, upon consideration of certain adjustments made by the staff, the record shows that this volume of gas is not an estimate of all the gas to be delivered in 1963 but is limited to that which can be handled by the normalized March 31, 1962, test year facilities.

In our opinion, United misconceives the purpose of the Commission's regulations with respect to a filing of a proposed rate change. The Commission intended, as United notes, that its amended regulations expedite proceedings by providing for the submission of extensive data in support of the rate filing, so that this material would not have to be obtained in a time consuming investigation after the filing of the proposed changes. The Commission stated in amending its regulations, again as noted by United, that the applicant might adduce additional material or present data on a different basis to the extent desirable, but that the supplemental material must relate to the prescribed test year (28 FPC 495). Obviously adjustment by the company may require offsetting adjustments by other parties. In the past we have used a test year "with adjustments for know... changes occurring within a reasonable time." Panhandle Eastern Pipe Line Co., 25 FPC 787, 795, remanded on other grounds Panhandle Eastern Pipe Line Co. v. F.P.C., 305 F. 2d 763, (CADC, June 30, 1962), certiorari denied 372 U.S. 916; see also El Paso Natural Gas Co., 22 FPC 260, 263, remanded on other grounds El Paso Natural Gas Co. v. F.P.C., 281 F. 2d 567 (C45), certiorari denied 366 U.S. 912. The objective is to present adjustments to the test year figures which will match additional expenses with additional income as close as is reasonably possible. What is reasonable obviously depends upon the circumstances. Since extensive facilities were put into service in 1962, so as to change the company's operations substantially in 1963, it was proper to employ 1963 volumes of gas with the March 31, 1962 test year cost of service adjusted incrementally to these increased volumes of gas.

COST OF SERVICE

There are several cost of service matters at issue between the parties. These include purchased gas costs (including the amount paid to United's affiliate, Union Producing Company), federal income taxes, and the computation of the rate base including the question whether there should be an allowance for prepaid gas costs.

A. Purchased Gas Costs - The cost of purchased gas represents about 75 percent of United's cost of service. 5/ Controversy arises over

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5/ $249,169,755 out of a total cost of service of $325,731,603, as determined herein.

the estimated purchasing pattern for the year 1963 compared with the test year ending March 31, 1962. United's average cost of gas purchased during the base year was 17.71 cents per Mcf. Under its adjusted gas purchase pattern for 1963, including increased takes from the higher priced fields in Southern Louisiana, the unit cost rose to 18.40 cents. The witness for United testified that the purchase pattern was one of judgment in applying a formula which took into account a number of factors including the capacity of its system, availability of gas, state conservation statutes, the takes of other purchasers within the field and drainage conditions. The staff, on the other hand, argued that United had not taken into account the element of cost. It constructed a purchase pattern of its own for the Houston and Lafayette districts. It used United's adjusted average cost of gas derived from United's adjustment of test year costs and volumes to November 30, 1962. On our part we are convinced by the evidence that the dispatching of gas from the various fields to meet the obligations of the pipeline is a very complicated activity particularly in view of contract obligations and the state regulation of takes. An adequate supply of gas might be threatened if United were to be required to take the lower priced gas. It seems obvious to us that if United were required to use the lowest priced gas first, it would result in an accelerated increase in purchased gas costs.

As set forth by the examiner whose views we are adopting here, United included in its purchased gas costs approximately $18,600,000 paid to Union, a wholly owned gas producing subsidiary of United's parent, for approximately 131,000,000 Mcf of gas at an average cost of 14.2 cents per Mcf. The prices used by United are based on rate schedules of Union filed with this Commission. To support the prices paid, United put in a complete cost of service case based on Union's 1961 costs. Staff and interveners moved to dismiss this evidence on the ground that Union's rates were the subject of a proceeding in Docket No. G-13811. The examiner granted the motion on the ground that the Union proceeding provided an adequate vehicle for the determination of that portion of United's cost of service represented by gas supplied by Union and to turn this pipeline rate proceeding into a de novo full-blown investigation of the economic justification of Union's price to United would duplicate a producer rate proceeding. In his decision the examiner reaffirmed this position.

Applicable to this proceeding is the authority of Mississippi River Fuel Corp. v. F.P.C., 252 F.2d 619 (CADC), certiorari denied 355 U.S. 904. There in a case involving United's rates the Commission said that while it was empowered to inquire into United's contract prices with Union, it was not required to do so and its not doing so was a reasonable exercise of administrative discretion. The court, however, held that the Commission should have inquired into Union's prices saying:

"Therefore we think the Commission must at least inquire into the factual justification for the price increases paid by United to Union. By this we mean that to include the increased prices in the costs of United the Commission must at least determine that the increases were justified by reason of Union's costs or by reason of some other stated end of the Natural Gas Act; the Commission must ascertain that they were not mere bookkeeping or intra-corporate-system adjustments. We must remand the case for that inquiry. We do not hold that a full-blown inquiry into the rates of Union is necessary. Subsequent developments in the proceeding may or may not indicate such a necessity."

In Willmut Gas and Oil Company v, F.P.C., 299 F.2d 111 (CADC) the Commission also had rates of United before it. After the decision in the Mississippi River Fuel case United sought to reopen the hearing so that evidence might be offered to substantiate the amounts for cost of gas purchased from Union. The Commission refused to receive such evidence, but on review confessed error and asked that matters be remanded for further proceedings concerning the factual economic justification for Union's charges.

In view of these decisions it is entirely clear that we would be remiss in accepting Union's filed rates for United's purchased gas costs. The courts, in effect, place the filed rates of an affilate in a different category than those of a non-affiliate. This follows reasonably because, as the court said, we are dealing with a single corporate structure. We must therefore do something more than accept the filed rates, as United would have us, but we are not required to include a full-blown inquiry into Union's rates in the present proceeding.

We have a means of meeting the requirements of the court in these cases without initiating another rate case for Union. We have had before us the proceeding in Docket No. G-13811, et al., relating to Union's rates. This is an investigation under Section 5(a) of the Act consolidated with eight Section 4(e) dockets covering nine rate schedules of Union's charges to United. Of the eight Section 4(e) dockets involved 6/ only three have not been superseded by subsequent rate filings and represent sales in 1963. 7/ In our Opinion No. 414 issued on January 9, 1964 we determined that Union had

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6/ G-13811, G-13820, G-14114, G-14352, G-14553, G-16725, G-17589, and G-17606.

7/ G-14114, G-14552 and G-17589 excluding the effect of a filing to reflect the unconstitutional Louisiana gas gathering tax. (See Appendix 3.)

failed in its proof to support the Section 4(e) rates, but that the record was not sufficient to make a determination of Union's rates for the future particularly with respect to the matter of depletion. Therefor we disallowed Union's increased rates proposed in the Section 4(e) dockets and remanded the proceedings so that the record could be amplified for the purposes of the Section 5(a) investigation (Docket No. G-18354). In doing so we required that Union adduce evidence with respect to a more current test year.

In the present proceeding it would be inappropriate to determine Union's rates even if the record were complete, for it would be wasteful to determine Union's rates in two proceedings possibly with inconsistent results. We shall therefore leave the question of the cost of gas purchased from Union undecided to await the final result in the Union case. This, in our opinion, will meet the criteria of the court in the Mississippi case that a factual economic justification for Union's rates be shown. For the period here involved beginning with January 1, 1963, we shall accept as United's purchased gas costs Union's filed rates (even though subject to suspension in other proceedings) except for the filed rates covered by dockets in the Union case and still not superseded. In the case of those unsuperseded Union rates we shall accept only the rates in effect previous to the Union case filings, for we have already found those rates unjustified. Upon final determination of Union's rates we shall require United to file rate reductions if appropriate and to refund to its customers amounts which represent the difference between what it has paid for gas and what it should have paid if the rates finally determined in the Union case had been in effect.

studies, as noted, were based on a period extending back to 1949, but since the unit costs and incremental costs levelled out with some variations at about 2 cents in the 1954-1961 period we shall use the rounded figure of 2 cents to compute the adjustment of operating expenses so as to reflect the 1963 gas volumes. This, of course, does not prevent us finding in another case and under different circumstances that additional volumes of a pipeline's gas can be sold without an equivalent increase in operating expenses so that the unit operating cost of the additional gas would, indeed be lower than the unit operating cost of the original gas. The Commission is not ruling that the method of determining incremental costs in this opinion is the only acceptable method.

Apart from the 2-cent factor United has made certain errors, in computing its adjustment to operating expenses as contended by the Eastern Intervenors. United computed its incremental volume to be 86,868,613 Mcf apparently by deducting its adjusted March 31, 1962, test year volumes in the amount of 1,310,305,755 Mcf from the estimated 1963 volumes in the amount of 1,397,174,368 Mcf. 8/ Its adjustment of the test year volumes was apparently to compensate for loss of certain sales, but it made no corresponding adjustment in operating expenses. Therefore we shall subtract the unadjusted test year volumes in the amount of 1,323,015,653 Mcf from the 1963 estimated volumes of 1,397,174,368 Mcf to arrive at an incremental volume of 74,158,715 Mcf and an incremental cost (at 2 cents per Mcf) of $1,483,174 instead of United's $1,737,372, thus reducing United's incremental cost by $254,198.

Further, United added $224,514 in operating expenses reflecting the new 30-inch North Louisiana pipeline and a 36-inch pipeline from the Bastian Bay Field. Since the 2-cent cost allowance is designed to take into account all increases in cost, this adjustment represents an additional allowance for the same thing and should not be included in the allowance for the additional volumes of gas. Also United indicated that an amount of $349,237 should also be eliminated from operating expenses representing expenses under an agreement with Texas Gas for transportation which had ceased. Therefore using the 2 cents per Mcf for the incremental gas and taking into account the adjustments shown above there results an allowance for operating expenses, other than purchased gas costs, in the amount of $27,001,997 as shown in Appendix 2 hereto.

As discussed below in connection with taxes there is an issue herein as to whether we should deduct charitable contributions in the amount of $163,322 in computing the income tax allowance. We believe that contributions of a reasonable amount to recognized and appropriate charitable

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8/ Composed of estimated transportation volumes of 53,471,155 Mcf and sales volumes of 1,343,703,213 Mcf.

institutions constitute a proper operating expense. 9/ Corporations have an obligation to the communities in which they are located and they are expected to recognize this obligation. It is our opinion that these contributions have an important relationship to the necessary costs of doing business.

According to the record, the sum claimed by United is deductible for Federal income tax purposes. Moreover, it represents only about one-twentieth of one percent of United's cost of service. In these circumstances, we shall allow the item of $163,322 as an operating expense; take it into account in computing working capital like other operating expenses; and allocate it in proportion to administrative and general expense. 10/

C. Federal Income Taxes - In its cost of service United has included Federal income taxes in the amount of $12,751,454 calculated at the 52 percent statutory rate in effect at the time the record was closed. We shall use the 52 percent rate as a basis of our computations for it applied through 1963, the first year that our prescribed rates are

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9/ As a maximum we would allow contributions to those organizations included in the Cumulative List, Organizations described in Section 170(c) of the Internal Revenue Code.

10/ I have prepared this opinion to express the views of the majority, but at this point note my individual disagreement with the Commission's new rate-making treatment of charitable contributions. Such payments, as commendable as they may be, are properly accounted for as income deductions, not operating expenses. They bear no relationship whatever to the necessary costs of providing utility service and therefore should not be borne by the utility customers. Charitable contributions, if made by the Company, should be the sole responsibility of the stockholders. It is argued that a public utility has a community and civic responsibility and should therefore be encouraged to support deserving charities. I agree. But the financial burden of donations to charities should not be shifted to the consumer who had no voice in their selection. A contribution to a charitable organization is uniquely a matter of personal choice and should not be hidden in a customer's gas bill, especially when its beneficial effect may be far removed from his community.

effective. We shall require, however, that United file rate changes to reflect the statutory rates of 50 percent in 1964 and 48 percent in 1965 as prescribed in the Revenue Act of 1964. 11/

1. The Effect of the Consolidated Return.

A question is raised as to United's share of the federal income tax paid through a consolidated tax return filed by United Gas Corporation, its parent. Joined in the return are the subsidiaries, United, Union, and United Overseas Production Corporation. In most years Union shows a loss 12/ with a resulting reduction in taxes for the consolidated group. However, United contends that it is entitled to apply to its taxable income the statutory income tax rate in computing the amount of federal income taxes includible in its cost of service unreduced by utilization of tax reductions and losses attributable to the unrelated, nonjurisdiction and non-utility-operations of affiliated companies.

The question here involved has already been determined by us in Cities Service Gas Company, ___ FPC ___, Opinion No. 396, Docket No. G-18799, Issued July 15, 1963. In that proceeding we stated that the proper method was to (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups and among the companies in the regulated group, on the basis of their respective taxable incomes.

Before making the computation prescribed in Cities Service, it is necessary, as in that case, to decide on the period of time to be used in the computations. The record shows extensive data for the five-year period 1957-1961, and since there are substantial variations in the taxable income for those years, a period as long as this is reasonable. The record does contain some evidence on the year 1962; but, this evidence is in part composed of estimates, and, in any event 1962 is not a typical year for United for tax purposes, because of the rate refunds made that year. Therefore for the purpose of the tax computations we shall use the five-year period 1957-1961.

In making a separation between the regulated and non-regulated companies we find that United is largely a regulated company, and we shall designate it as such for the purpose of these computations. United Gas Corporation engages in the distribution of gas and its rates are variously subject to regulation by state commissions and municipalities.

11/ Public Law 88-272.

12/ United Overseas was not included in the consolidated return until 1961 when it showed a small tax loss.

There is no regulation involved in connection with its sale of gas appliances, appliance repair services, research, and the receipt of interest and dividends. However, since this non-regulated portion of its business is closely connected with the regulated and the record makes no separation, we shall consider United Gas Corporation in the regulated category. Union is engaged in the sale of natural gas, natural gas liquids and oil. Only the sale of gas is subject to regulation. While the record would permit an allocation of Union's taxable income between its regulated and non-regulated business, arithmetically, this would make no difference because Union has a net taxable loss over the 1957-1961 period, and no part of the consolidated tax would be allocated to it whether it be classified as regulated or non-regulated. United Overseas operates entirely outside the United States and is engaged in an oil exploration project in Tunisia, North Africa, so that it is in the non-regulated category. No portion of the consolidated tax would be allocated to it in any case because it produced a loss. 13/

As shown in Appendix 5 hereto the net total consolidated tax liability for the United companies for the 1957-1961 period amounts to $57,199,881. The average for one year amounts to $11,439,976. In accordance with the Cities Service case the latter amount is allocated between United Gas Corporation and United Gas Pipe Line in proportion to their respective taxable incomes for the 1957-1961 period as shown in Appendix 5. United Gas Pipe Line's share, in accordance with this computation, amounts to $10,537,362, using the 52 percent statutory tax rate. This represents an effective tax rate of 50.04 percent based upon the five-year average. When this effective tax rate is applied to United Gas Pipe Line's test year, it results in a federal income tax allowance of $9,940,892 as shown in Appendix 4 below, subject, of course, to the rate reductions we require for the lowered tax rates in the year 1964 and again in 1965.

2. Failure to Use Liberalized Depreciation and IRS Guideline Depreciation Rates.

Memphis contends that the tax laws, regulations and procedures permit the use of liberalized depreciation and of the guideline depreciation rates of the Internal Revenue Service 14/ for determining United's income tax liability, and that the Commission in computing United's tax allowance for cost of service, should treat United as if it had availed itself of these statutory provisions, irrespective of whether the parent,

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13/ It appears in the consolidated return only in 1961 when its loss was $24,354.

14/ Section 167 of the Internal Revenue Code and Depreciation Guidelines and Rules, I.R.S. Publication No. 456; Tables for Applying Revenue Procedure 62-21, I.R.S. Publication No. 457.

United Gas Corporation, had in fact utilized them. Memphis has failed to make a showing that the public interest requires us in this case to treat the company as though it makes use of these statutory provisions contrary to its actual practices.

3. Gas Prepayments.

The issue of the tax effect of gas prepayments presents two important questions: the effect of the prepayments on the tax allowance in the cost of service; and the effect of the accumulated prepayments on the rate base. Technically, a gas prepayment is the amount that United has been required to pay in accordance with the take or pay provisions of its gas purchase contracts in excess of payments for gas actually taken. United claims these prepayments as deductions in its tax returns for the years in which they were made. However, in computing the test year cost of service in this proceeding United has treated the prepaid gas expense as deferred charges and has not included them in computing either its tax allowances or its cost of purchase gas in its cost of service for the test period. Thus only when delivery of the prepaid gas is ultimately taken would the cost of service reflect the corresponding prepayment charges. United does, however, include an amount of $5,937,060 representing an average test year balance of prepayments in its working capital for inclusion in the rate base.

Memphis contends that this is improper; that United is entitled to and in fact takes a tax deduction for these gas prepayment charges in the years in which they arise and that it should be required to reflect these actual tax deductions in the test year period as well. On the other hand, staff and the examiner, with certain modifications, accept United's position that prepayments should not be deducted in determining the tax allowance in the cost of service. We agree with this position. Test year costs must often depart from the actual results in order to reach rates reasonable for the future. The record shows that United expected to incur deficiencies in the volumes of gas taken in 1963, but, subject to several contingencies, expected to be in balance during 1964. Beginning in the year 1965 United anticipates that it can begin to make up the deficiencies previously incurred. Whether these predictions are precisely accurate, we can conclude that the prepayments are non-recurring. Since we are determining rates prospectively, any decrease in the actual taxes in the test year will disappear in those years when the prepaid gas is actually consumed, and this promises to be in the near future. Thus a more representative tax allowance can be computed by not using the gas prepayments as deductions.

Further, we agree with the staff and the examiner that accumulated prepayments should be included in working capital. These amounts are expended in order to retain an available supply of gas and precede by several years the receipt of the related revenues to be realized when

the gas paid for in advance is made up and sold. While the record indicates that the balance of prepayments, amounting to $15,340,800 on December 1, 1962, may be reduced beginning in 1965, they represent an investment of cash on which a return should be realized for some years in the future. United would include in working capital only the average test year amount of $5,937,060 rather than the full accumulation. We think the lesser amount more representative of the future and shall employ it in computing working capital.

The examiner, following the contentions of the Eastern Intervenors, would reduce the credit to working capital for prepaid gas by the amount of taxes saved in using the prepayments as a deduction. 15/ We agree with this in principle. If United has saved taxes in making its prepayments, its investment is correspondingly reduced. However, the record indicates that although the prepayments are claimed by United as tax deductions, they may eventually be disallowed. In that case United would have no way of recovering the revenues lost as a result of reducing the credit to working capital. We will provide that United shall adjust its rates and make appropriate refunds when and if it is finally determined that the prepayments were properly deductible on its tax returns. To achieve this result with a minimum of dispute, we shall direct United to establish a special account out of earned surplus to reflect deductions taken by virtue of these prepayments.

4. Regulatory Treatment of the Investment Tax Credit.

United's cost of service presentation makes no provision or allowance for reductions in its income tax expenses attributable to the investment tax credit authorized by the Internal Revenue Act of 1962. 16/ Staff and Memphis argued that this was improper in that the investment tax credit was a tax reduction and hence an increase in United's net income. Thus they argued that, like any other tax reduction or savings, the credit must be reflected by an equivalent reduction in United's cost of service, with the result that these savings would flow through to net income and United's customers would have the benefit of the lower cost of service. As we have indicated, this issue has been rendered moot by the action of Congress prescribing that regulatory agencies shall not use such investment taxes for the purpose of establishing the company's cost of service without the consent of the company. 17/ Our cost of service shall, therefore, make no adjustments for, or otherwise give consideration to the investment tax credits which United may qualify for under the tax law.

15/ The examiner used the accumulated prepayments in the amount of $15,340,800 less 52 percent less the related income tax reductions to working capital.

16/ 26 U.S.C. § 38, 46-48.

17/ Revenue Act of 1964, Public Law 88-272, Section 203(e).

5. Tax Deductions.

The staff, and Memphis in part, have criticized the examiner for not finding that Federal and state income tax allowances should be based on (a) the more recent 1961 tax return data; (b) the five-year average of tax deductions for property abandonment losses, taxes capitalized, employee benefits capitalized and additional expenses capitalized during the years 1957-1961, inclusive, instead of the years 1956-1960, inclusive; (c) the $163,322 tax deduction for charitable contributions reflected in the 1961 return; and (d) the staff's proposed interest expense tax deduction of $10,772,145 based upon United's outstanding debt capital and actual interest rate as of November 30, 1962. In our opinion all of these factors except item (c), the charitable tax deductions, should be taken into account in computing United's tax allowance. Items (a) and (b) take advantage of more recent data available in the record, and United specifically does not object with respect to item (b), the five-year averages. Item (c), the charitable contributions, is being treated as an operating expense. As such it is automatically deducted in computing the income tax allowance since elements in the cost of service other than return are excluded from the computation. Accordingly, it should not be deducted a second time from return in completing the computation. On item (d), computation of interest as of November 30, 1962, United argues that this figure does not reflect the future in that its debt capitalization is subject to amortization and will be reduced after that date. Our purpose has been to adjust the base year ending March 31, 1962, in the light of the substantial amount of new facilities installed by United through November 30, 1962. Hence we have included in the rate base plant added up to that date. In our opinion the use of the additional plant in the rate base requires the use of the corresponding debt capitalization in the income tax computation.

COST ALLOCATION AND ZONE RATE DIFFERENTIAL

This Commission has, historically, favored rolled-in methods of allocation so that all customers will share equally in the costs of a pipeline system, unless the length of the pipeline required zone differentials. 20/ United, however, has traditionally been recognized as an exception to this principle, mainly because it has, in the past, operated two essentially separate jurisdictional systems, a line from Agua Dulce, Texas, extending northeasterly to Sterlington, Louisiana and a line from Lirette in southern Louisiana northward to central Mississippi through Jackson. But this is in the process of change as the result of the recently constructed line running from Bayou Sale in southern Louisiana to a point near Sterlington. The rates in each of these systems have in turn been subdivided into zones or rate areas where "substantially the same operating and natural conditions prevail, starting with the premise that the widest areas practicable in terms of average costs and physical characteristics of service should be designated." 21/ There have been four zones called the Southwest, Central, New Orleans, and Jackson Zones as shown on the attached map. 22/ Southwest and New Orleans are largely gas supply zones; Central and Jackson are largely gas sales zones. Thus, the problem of the allocation of United's cost of service and the formulation of just and reasonable rates is complicated by United's historical pattern of operations.

United's system of zone rate differentials has had a long history before the Commission. 23/ It was considered most lately in the Commission's order of January 4, 1961, cited. There various modifications of the allocation of costs, known as "Method 8" and previously approved by the Commission, were proposed. Under Method 8 the purchased gas costs and the transmission costs of the New Orleans Zone were computed and applied to the New Orleans Zone and carried forward and applied with additional purchased gas and transmission costs of the Jackson Zone to that zone.

20/ Trunkline Gas Co., 21 FPC 704, 711, aff'd as Battle Creek Gas Co. v. F.P.C., 281 F.2d 42 (CADC 1960); Kansas-Nebraska Natural Gas Co., 25 FPC 448, 453. See also Louisiana Public Service Commission v. United Gas Pipe Line Company, et al., 3 FPC 402, 404, 405.

21/ Louisiana Public Service Commission v. United Gas Pipe Line Company, et al., supra.

22/ The Southwest Zone included the Lafayette Zone now proposed by United.

23/ See United Gas Pipe Line Co., 3 FPC 402; 13 FPC 396; 14 FPC 353, 406, aff'd as to allocation Mississippi River Fuel Corp. v. F.P.C., 252 F.2d 619 (CADC 1957), cert. den. 355 U.S. 904; 25 FPC 26, January 4, 1961.

Likewise, the costs of the Southwest Zone were applied to that zone and carried forward to the Central Zone and added to the costs of that zone. The effect of this was to permit the Southwest Zone customers in Texas, as well as the Central Zone customers, to benefit from the lower producers prices of that zone. On the other hand the New Orleans Zone and Jackson Zone customers would be subject to the higher gas prices in Louisiana.

The Commission justified Method 8 in its January 4, 1961, order (25 FPC at p. 31) on the ground that United's system was, in fact, two separate systems with smaller interconnecting facilities. That is one system ran north from southern Louisiana and the other ran northeast from southern Texas. It also pointed out that the daily take from Texas sources was greater than necessary to serve all nonjurisdictional Texas customers, and that the direction of the gas flow on the Texas part of the system was away from the Southwest Zone and into the Central Zone. Likewise the flow from southern Louisiana sources was to nonjurisdictional customers in Louisiana and north into the Jackson Zone. The Commission noted it would take a major shutdown and flow reversal to cause any substantial flow of southern Louisiana gas into the Southwest or Central Zones.

As the examiner finds, there is a change in this pattern of operation today. The record shows that a large net flow still exists from the Southwest Zone to the Central Zone on the Agua Dulce and smaller lines and from the New Orleans to the Jackson Zone. However, it is now estimated that gas approximately equal to the other Southwest volumes would flow from the eastern part of the Southwest Zone, proposed to be called the Lafayette Zone, into the Central Zone on the new 30-inch pipeline during 1963 and that with additional capacity this flow would be greatly increased in the 1963-1964 heating season. There is also estimated a heavy flow from Bayou Sale in the New Orleans Zone into the proposed Lafayette Zone on the new 30-inch interconnection, and there is a relatively small flow (that has existed from 1950) from the Jackson Zone into the Central Zone on an 18-inch line. The record shows that the flow in the new 30-inch line from southern Louisiana into the Central Zone at Sterlington is to meet deficiencies in the supply of gas to the Central Zone customers and is an essential part of United's operations.

In the light of these developments a number of methods for allocating United's costs were proposed by various parties to the proceeding. United itself proposed a variant of Method 8 by establishing the separate Lafayette Zone shown on the map in Appendix 1 hereto, which was formerly a part of the Southwest Zone. United points out that gas flows from the New Orleans Zone to the proposed Lafayette Zone and, together with additional volumes contributed by the Lafayette Zone, is transported on the new 30-inch line up to the Central Zone. Alternatively on rebuttal United merged the Lafayette and New Orleans Zones, thus in effect transferring what was Southwest Zone territory to the New Orleans Zone. As a further alternative United would combine the Central and Jackson Zones. We agree with the examiner that the establishment of a new zone or the

shifting of territory is not justified at this stage in the development of the system, which is becoming more unified and will call for more departures from Method 8 in the future as indicated below.

The staff, on the other hand, departed from Method 8. It allocated purchased gas costs directly to those of United's nonjurisdictional sales in the New Orleans and Southwest Zones that were made from facilities that were considered to be intrastate and physically separate from United's interstate system. The staff then rolled-in jurisdictional purchased gas costs on a system-wide basis. Adjustments were then made to give effect to the lower cost of sales in the New Orleans Zone and the lower cost of transportation in the Central Zone.

While we favor rolled-in methods of allocation, in our opinion the United system has not yet developed to this stage. Any rates established in line with such a rolled-in allocation would be too disruptive of business relationships in view of the historical patterns. Therefore we do not approve at this time of the staff's proposed roll-in of costs, but we expect that future allocations of United's costs will trend in the direction of a complete roll-in. However, we find that the staff's method of separating the purchased gas costs of nonjurisdictional sales made from intrastate facilities in the New Orleans Zone and in the Southwest Zone (including the proposed Lafayette Zone) was appropriate, and we have carried out that separation as shown in Appendix 6 hereto. As can be seen, almost all of the nonjurisdictional sales in the New Orleans Zone are subject to the direct assignment of purchased gas costs, and the greater part of those in the Southwest Zone are also treated in this way. We think it a desirable principle of rate making that costs should be directly assigned whenever feasible, and cost allocation with all of its complexities should be employed only when necessary. As witness for the Eastern Interveners testified, jurisdictional customers should not be burdened by the costs of nonjurisdictional purchases which are not subject to regulation by the Commission.

United objects to this separation of purchased gas costs contending that the intrastate facilities from which these nonjurisdictional sales are made are not, in fact, separable (at least in the Southwest Zone), and, further, that it is inequitable to make a separation of purchased gas costs without at the same time making a separation of transmission costs. The record shows the intrastate facilities in the New Orleans Zone are entirely separate; the books are separate; and operations are carried on in partnership with another company. In the Southwest Zone the separation is less simple. It appears that a relatively small amount of gas sold under rate schedules on file with the Commission is necessary in addition to the gas from unfiled rate schedules to make the full amount of sales from the facilities designated by the staff as intrastate. Furthermore, some of the

separated sales of intrastate gas in Texas are made from facilities that may carry interstate gas. In spite of these possible qualifications, in our opinion, the staff made a reasonable separation of facilities and sales in the Southwest Zone that largely reflects the company's operations and is a closer approximation to reality than conventional allocation. With respect to transmission costs we would assign these directly as well as the purchased gas costs, but on the record the transmission costs are not separable so as to permit their direct assignment.

Memphis asks that the Southwest Zone be expanded to include low priced gas from Eugene Island to the Bayou Sale Junction. This represents a further attempt to reserve certain gas supplies for certain customers and is inconsistent with the development of the system. In any case the need is obviated by the examiner's solution to the allocation problem discussed below, particularly the roll-in of the Central and Jackson Zones.

Interveners, Texas Gas, Mississippi River Fuel and UGI urge the retention of Method 8 on the ground that there is no reason to deviate from a method used in the past. We think that the operation of the new 30-inch line basically changes the operation of the system, and the method of allocation must accordingly be changed.

In the light of the contentions of the parties the examiner arrived at a method of allocation and adjustment of the rate levels that reflects the historical pattern of rates in the past yet gives effect to the changes that have occurred. The examiner would retain the separation of the present Southwest and New Orleans Zones. While he would not make the direct assignment of purchased gas costs to intrastate sales as prescribed here, he would determine costs separately for the two southern zones and carry the costs forward to the two northern zones, Central and Jackson, and he would roll-in the purchased gas costs for these two zones. This properly reflects the fact that the Central Zone is receiving large amounts of gas from the New Orleans Zone via the new line and will receive larger amounts in the future. 24/ We shall adopt the examiner's roll-in of the two northern zones

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24/ A large part of this New Orleans Zone gas is low priced gas from Eugene Island through Bayou Sale, but some gas does come south to the junction point at Bayou Sale from Duck Lake. At any rate the low priced gas formerly went into the Jackson Zone and presumably is only available to the Central customers because the Jackson customers take larger amounts of other New Orleans Zone gas.

as a logical outcome of the development of United's system. We shall extend this allocation to transmission costs as well as purchased gas costs, because the two northern zones are both becoming dependent on the producing regions of both southern zones. In performing the allocation we think that the two zones should be rolled-in before an allocation is made to jurisdictional and nonjurisdictional customers since it is our intention to treat the two northern zones as one.

While strictly a matter of rate design, the examiner's treatment of the rate levels in the Central and Jackson Zones should be considered in connection with his method of allocation. He found, we think with ample justification, that a differential between the two zones was necessary, for a roll-in of purchased gas costs with no price differential would increase the Central Zone rates by some six million dollars a year. In order to avoid this disruptive result he adopts a price differential of 3.5 cents in the commodity component of the rate to give weight to both cost and historical considerations. Furthermore, in order not to make a sudden change in prevailing rate patterns, he would leave the presently effective Central Zone rates in effect and apply all decreases in the cost of service, including reductions in purchased gas cost, to the Jackson rates until the 3.5-cent price differential is reached. We will adopt his differential between the zones, which, in our judgment is appropriate although we are aware that certain of the interveners contend it is too much and others contend it is too little. However, we do not adopt the examiner's conclusion that the presently effective Central Zone rates should remain in effect, and that the 3.5-cent differential should be reached only as a result of reductions in the cost of service. The amount of such reductions is unknown, and we think that a definite differential should now be put into effect representing a reduction in the present differential between the zones.

In our opinion the 3.5-cent differential represents a reasonable step in this transition period toward a more complete roll-in of United's costs. We note, furthermore, that the differential was around 3 cents in accordance with the Commission's approval of settlement rates in 1954, 25/ but later filings have shown higher differentials ranging up to 8.00 cents per Mcf. More recently, however, these differentials have shown a tendency to decrease, reaching 5.76 cents in United's filing of substitute rates in RP63-1. Of course, settlement rates and filed rates are not evidence of what rates should be or differentials should be, but do indicate economic trends. The record here shows that the differential increased in response to the flow of higher priced southern Louisiana gas to the Jackson Zone, and decreased more recently because of the flow of southern Louisiana gas to the Central Zone and because of the tendency of gas prices to level off.

In conclusion we believe adoption of the examiner's approach as reflected in Appendices 2 and 6 attached gives weight to the methods of allocation used by us in the past, and to the changing pattern of operations. There is nothing to show that it will cause loss of United's nonjurisdictional business in Texas or will upset customer relationships in the two northern zones. It is to be understood that it is not the final word in the allocation of United's costs. In a future proceeding the United system may be found to be even more an integrated network than it is now. At that time a more complete roll-in of costs may be appropriate. As oft said, "The problem is to allocate to each class of the business its fair share of the costs. * * * Allocation of costs is not a matter for the slide rule. It involves judgment on a myriad of facts. It has no claim to an exact science." Colorado Interstate Co. v. F.P.C., 324 U.S. 581, 588.

25/ United Gas Pipe Line, 13 FPC 398, 406.

UNITED GAS PIPE LINE COMPANY, Docket No. RP63-1

Computation of Federal and State Income Tax Allowances
Related to Estimated 1963 Sales

Description (1)	Tax Calculation (2)	Reduction of Working Capital for Federal Income Tax (3)	Return and Tax (4)
Rate Base			
Net plant	$364,855,025		$364,855,0
Working capital	13,610,537	(4,971,089)	8,639,4
Total	$378,465,562	(4,971,089)	$373,494,4
Return at 6.5%	24,600,261		24,277,2
Less .484137D 1/			
.484137 x $14,350,856	6,947,780		
	17,652,481		
Return and tax $17,652,481 ÷ .515863 2/	$ 34,219,320		
Computation of Federal income tax:			
Return and tax	$ 34,219,320		
Less tax deductions	14,350,856		
Taxable income	19,868,464		
Tax at 50.04%	9,942,179		9,942,1
			$ 34,219,3
50% of federal income tax as source of working capital	$ 4,971,089		
Computation of State income tax:			
Taxable income	$ 19,868,464		
Tax at 1.794%	$ 356,520		

1/ Derivation of .484137D: .5004D less [(.065) (.50) (.5004)]

2/ Derivation of .515863: 1.000000 less .484137

UNITED GAS PIPE LINE COMPANY, Docket No. RP63-1

Computation of Consolidated Effective Tax Rate

	Year 1957	Year 1958	Year 1959	Year 1960	Year 1961	Total	Percentage to Total
Consolidated taxable income, Exh. 36 Revised	$26,089,321	$30,955,531	$21,924,598	$15,936,714	$15,515,010	$110,421,174	
Deduct long-term capital gain	- 0 -	- 0 -	73,688	60,035	234,798	368,519	
Balance	26,089,321	30,955,531	21,850,910	15,876,679	15,280,214	110,052,655	
Tax at 52%	13,566,447	16,096,876	11,362,473	8,255,873	7,945,721	57,227,381	
Less surtax exemption	5,500	5,500	5,500	5,500	5,500	27,500	
Adjusted Consolidated Tax	$13,560,947	$16,091,376	$11,356,973	$ 8,250,373	$ 7,940,211	$ 57,199,881	
Taxable Income, United Gas Corp., Exh. 36 Revised	$ 2,743,517	$ 3,528,821	$ 2,939,594	$ 2,700,979	$(2,888,741)	$ 9,024,170	7.89
Taxable Income, United Gas Pipe Line Company, Exhibit 36 Revised	22,615,772	22,573,974	20,943,401	17,569,439	18,588,390	105,290,983	92.11
Total						$114,315,153	100.00
Percentage of United Gas Pipe Line to total						92.11%	
Consolidated tax for years 1957 - 1961						$ 57,199,881	
Average consolidated tax $57,199,881 ÷ 5 years						$ 11,439,976	
Portion of tax applicable to United Gas Pipe Line Co. $11,439,976 x 92.11%						$ 10,537,362	
Average taxable income of United Gas Pipe Line Co. $105,290,983 ÷ 5 years						$ 21,058,197	
Consolidated effective tax rate, $10,537,362 ÷ $21,058,197						50.04%	

United Gas Pipe Line Company
Jurisdictional Cost of Service
Related to Estimated 1963 Sales

Description	Total	Combined Central-Jackson Zone	Northwest Mississippi Zone	Southwest Zone	New Orleans Zone
Jurisdictional Cost of Service					
Production System					
Pipeline	$ 235,495	$ 235,495	$ -	$ -	$ -
Town Border	10,568	10,568	-	-	-
Total Production System	246,063	246,063	-	-	-
Transmission System					
Pipeline	116,258,106	111,698,072	-	4,560,034	-
Town Border	27,276,481	23,080,255	1,025,286	3,170,940	-
Total Transmission	143,534,587	134,778,327	1,025,286	7,730,974	-
Total Jurisdictional Sales	143,780,650	135,024,390	1,025,286	7,730,974	-
Tariff Transportation	1,857,118	1,857,118	-	-	-
Total Jurisdictional Service	145,637,768	136,881,508	1,025,286	7,730,974	-
Non-Jurisdictional Service	180,418,735	49,864,122	-	89,114,358	41,440,255
Total Cost of Service	$326,056,503	$186,745,630	$1,025,286	$96,845,332	$41,440,255

Only brief mention need be made of the issue concerning the consolidated tax question. The majority continues to defy the precise intent of Congress in granting the privilege of the consolidated return to an affiliated group of corporations. The law has wisely refrained from imposing a statutory requirement of assigning or distributing consolidated tax liability among members of the affiliated group. Hence a method of allocation adopted for the intersé purpose of the group is solely an internal affair. Each affiliate, including the parent, should accrue its tax liability as if its returns were filed on a separate basis. The reasons given in my dissenting opinion in the Cities Service case 20/ are equally applicable here and I so intend them to be.

20/ Cities Service Gas Company, Docket No. G-18799, Opinion No. 396 and accompanying Order, issued July 15, 1963.

[fol. 56] [File endorsement omitted]

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Nos. 21872 and 21958

UNITED GAS PIPE LINE Co., Petitioner,

v.

FEDERAL POWER COMMISSION, Respondent.

PETITIONS FOR REVIEW OF ORDER OF THE FEDERAL POWER COMMISSION

ORDER DENYING PETITIONER'S APPLICATION FOR STAY—October 21, 1964

Before RIVES and WISDOM, Circuit Judges, and MORGAN, District Judge.

PER CURIAM:

The petitioner's application for stay of the order of the Federal Power Commission is DENIED.

[fol. 57] [File endorsement omitted]

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 21872

UNITED GAS PIPE LINE COMPANY, Petitioner,

vs.

FEDERAL POWER COMMISSION, Respondent.

No. 21958

UNITED GAS PIPE LINE COMPANY, Petitioner,

vs.

FEDERAL POWER COMMISSION, Respondent.

MOTION OF PETITIONER FOR LEAVE AND PERMISSION TO WITHDRAW AND ABANDON CERTAIN ISSUES—Filed February 9, 1965.

To The Honorable, The Judges of the United States Court of Appeals for the Fifth Circuit:

Petitioner, United Gas Pipe Line Company (United) herewith applies to this Honorable Court for leave and permission to withdraw and abandon certain issues below described, and to restrict the issues to be heard to that below described, and that as to such issues withdrawn and abandoned such review proceedings to that extent be dismissed, and for grounds shows:

1

In October of 1964 following perfection of the above appeals in this Honorable Court, a number of United's [fol. 58] customers requested United to consider whether it might be possible to settle and dispose of all of United's rate proceedings then pending before the Federal Power Commission (FPC). For this Court's information, these involved certain issues reserved in a prior proceeding identified on the FPC Docket as RP61-18; the proceedings, orders and opinions in Docket RP63-1, which gave rise to the above appeals; and a subsequent rate increase proceeding

docketed at RP65-1, then in its preliminary stages on the Commission docket.

United, after consideration, made a proposal to its customers.

2

United's proposal to its customers led to conferences with the Staff of the Commission and all parties, which resulted in a settlement of all issues save and except the issue involving the use by the Commission of a consolidated effective tax rate, rather then the use of the applicable federal statutory corporate income tax rate in computing the federal income tax allowance in United's jurisdictional cost of service, an issue identified by all parties as the "consolidated effective tax rate issue." Being unable to reach agreement for disposition of such tax issue, the [fol. 59] Settlement Agreement excepted and excluded it from the settlement, and provided that such tax issue should be processed to final decision and judgment in these review proceedings. The Settlement Agreement required United, subject to Commission approval of the Settlement, to withdraw and seek dismissal of all issues reserved and tendered by United in its Motions for Rehearing and in the two above numbered appeals, except the consolidated effective tax rate issue.

This Honorable Court will find error assigned to the Commission's use of a consolidated effective tax rate, rather than the use of the applicable federal statutory corporate income tax rate in computing the federal income tax allowance in United's jurisdictional cost of service on pages 9 and 10 of the Petition for Review in No. 21872, and on pages 10 and 11 of the Petition for Review in No. 21958, above, the error being reserved by paragraph 3 of the Motions for Rehearing attached to each Petition for Review.

3

On December 23, 1964, the Commission issued its order approving the Settlement Agreement and approving the [fol. 60] provisions of that Agreement excepting and reserving for decision the consolidated effective tax rate issue posed as above described. This order became final on January 25, 1965.

To implement the Settlement Agreement so approved by the Commission order aforesaid, United files this application for permission to withdraw all issues in the two above numbered dockets, save and except the consolidated effective tax rate issue, and for an order dismissing such withdrawn issues. In this connection United shows that this Court has approved a briefing schedule which will continue to be applicable to and govern the filing of briefs upon such consolidated effective tax rate issue.

WHEREFORE, premises considered, United herewith applies to this Honorable Court for permission to withdraw the two above captioned appeals as to all issues involved therein *save and except* the issue involving the use by the Commission of a consolidated effective tax rather than the applicable federal statutory corporate income tax rate in computing the federal income tax allowance in United's jurisdictional cost of service, and for an order dismissing [fol. 61] such withdrawn issues, that the briefing schedule heretofore approved by this Court continue to control the preparation and filing of briefs upon the consolidated effective tax rate issue, and that this application be taken and deemed to be all action needed to accomplish such withdrawal and dismissal and the preservation of the excepted issue for decision, subject to approval by this Honorable Court.

United Gas Pipe Line Company, By /s/ Thomas Fletcher, 2025 First City National Bank Bldg., Houston, Texas—77002, Its Attorney of Record.

ORDER

Upon consideration of the foregoing Application, it is ORDERED that the above and foregoing review proceedings be and they are hereby dismissed as to all issues reserved and tendered save and except the issue involving the use by the Commission of a consolidated effective tax rate [fol. 62] rather than the applicable federal statutory corporate income tax rate in computing the federal income tax allowance in Petitioner's jurisdictional cost of service, and that the approved briefing schedule control the briefing of such reserved tax issue.

[fol. 63] [File endorsement omitted]

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 22041

TEXAS EASTERN TRANSMISSION CORPORATION, Petitioner,

v.

FEDERAL POWER COMMISSION, Respondent.

MOTION OF TEXAS EASTERN TRANSMISSION CORPORATION TO WITHDRAW APPEAL EXCEPT AS TO PARTICULAR ISSUES, TO SEVER RETENTION OF REFUND ISSUE AND TO POSTPONE PROCEEDINGS AS TO SEVERED ISSUE—filed February 9, 1965.

To The Honorable Judges of the United States Court of Appeals For the Fifth Circuit:

COMES Now Texas Eastern Transmission Corporation (Texas Eastern) and files this Motion to Withdraw Appeal Except as to Particular Issues, To Sever Retention of Refund Issue and to Postpone Proceedings as to Severed Issue, and as grounds therefor respectfully represents to the Court:

[fol. 64] 1

Motion to Withdraw Appeal Except as to Particular Issues

Texas Eastern moves the Court to permit the withdrawal of its above-captioned appeal except as such appeal relates to the issues of (1) the use by the Commission of a consolidated effective tax rate in computing the Federal Income Tax Allowance in the jurisdictional cost-of-service of United Gas Pipe Line Company (United)[1] and (2) the Commission's ordering United to hold and retain, pending further Commission order, amounts which United's jurisdictional customers contend they are entitled to receive as refunds.[2]

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[1] Assignment of Error (1) in Petition for Review.

[2] Assignment of Error (6) in Petition for Review.

As a jurisdictional pipeline customer of United, Texas Eastern filed its petition to review Opinion Nos. 428, 428-A and 428-B and accompanying orders issued by the Respondent, Federal Power Commission, in connection with a rate increase filed by United in Docket No. RP63-1.[3] Since [fol. 65] the filing of the appeal, United, its customers (including Texas Eastern), and the Commission Staff have agreed to a settlement of various issues in United's Docket No. RP63-1 as well as a settlement of issues in rate increase proceedings filed by United in Docket Nos. RP-61-18 and RP65-1. This settlement agreement disposed of all of the issues in the pending appeals filed in this Court by Texas Eastern, United, and the other pipelines with respect to the Commission's orders in United's Docket No. RP63-1 except the two issues enumerated above. By order issued December 23, 1964, the Respondent, Federal Power Commission, approved the settlement agreement and ordered the appeals to be withdrawn except insofar as they relate to the two issues reserved by the settlement agreement. Texas Eastern therefore requests permission to withdraw its appeal except as it relates to the two abovementioned issues.

2

Motion to Sever Retention of Refund Issue and to Postpone Proceedings as to Severed Issue.

Texas Eastern further moves the Court to sever the refund retention issue [Assignment of Error (6)] from the consolidated [fol. 66] tax issue [Assignment of Error(1)] and to postpone the filing of briefs and other proceedings[4] with respect to said refund retention issue.

In its order of December 23, 1964, approving the afore-

[3] Appeals of the same orders of the Commission were filed in this Court by United (Nos. 21872 and 21958), Natural Gas Pipeline Company of America (No. 22031), and Texas Gas Transmission Corporation (No. 22039).

[4] Pursuant to order issued by this Court, procedures were agreed upon for the filing of briefs, the joint appendix, etc. under which the initial briefs to be filed by Texas Eastern and the other pipeline petitioners are due March 8, 1965.

mentioned settlement in United's Docket Nos. RP61-18, RP63-1 and RP65-1 the Commission, as in its prior orders in Docket No. RP63-1, ordered United to hold and retain, pending further order of the Commission, certain refunds which Texas Eastern contends it is legally and equitably entitled to receive now. In accordance with Section 1.34 of the Commission's Rules of Practice and Procedure and Section 19(a) of the Natural Gas Act, Texas Eastern has filed an Application for Rehearing of the Commission's order of December 23, 1964,[5] insofar as it directs United to hold and retain certain refunds due Texas Eastern pending further order of the Commission.

This Application for Rehearing urges, *inter alia*, the same errors as to the Commission ordering the retention of refunds by United as are urged in Texas Eastern's pending [fol. 67] appeal in No. 22041 [Assignment of Error (6)]. The Application for Rehearing is presently pending before the Commission. If it is granted the refund issue in Texas Eastern's pending appeal will be rendered moot. If the Application for Rehearing is denied, Texas Eastern intends to file a petition for review in this Court which will necessarily duplicate in large part its present appeal in No. 22041 insofar as the retention of refunds by United is concerned.

Therefore, if Texas Eastern's pending Application for Rehearing is granted the severance and postponement proposed herein will avoid burdening the Court and the parties with lengthy briefs, arguments, etc. related to an issue which will be moot. On the other hand if the pending Application for Rehearing is denied, the procedure proposed by Texas Eastern will avoid the duplication of briefs, arguments, etc. which would result if the refund retention issue raised in Texas Eastern's present appeal in No. 22041 is heard separately from its appeal of the Commission's order of December 23, 1964, in Docket Nos. RP61-18, RP63-1 and RP65-1.

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[5] The Application for Rehearing also complains of the Commission's order issued December 31, 1964, denying Texas Eastern's telegraphic objections to the provisions of the December 23, 1964, order as required by ordering paragraph (K) thereof.

[fol. 68] Texas Eastern proposes to proceed with its appeal of the consolidated income tax issue in accordance with the procedures previously agreed upon and ordered by this Court and to file its initial brief on such issue with the Court in accordance with the stipulations of the parties and the orders of this Court.

Texas Eastern is authorized to inform the Court that the Respondent, Federal Power Commission, has no objection to the granting of this motion.

Wherefore, Petitioner Texas Eastern Transmission Corporation respectfully prays that the Court enter an order:

(1) Permitting Texas Eastern to withdraw and dismiss its appeal in No. 22041 except as such appeal relates to the consolidated tax issue and the refund retention issue as detailed above;

(2) Severing the refund retention issue from the consolidated tax issue and postponing proceedings with respect to such refund retention issue pending further proceedings in connection with Texas Eastern's Application for Rehearing of the Commission's order [fol. 69] issued December 23, 1964 in Docket Nos. RP61-18, RP63-1 and RP65-1; and

(3) Granting Texas Eastern such other and further relief as may to the court appear to be just and equitable.

Respectfully submitted, /s/ David T. Searls, J. Evans Attwell, Vinson, Elkins, Weems & Searls, 2100 First City National Bank Building, Houston, Texas. 77002. Jack D. Head, P. O. Box 2521, Houston, Texas. 77001. Keith M. Pyburn, 425 13th Street, N. W., Washington, D. C., Attorneys for Petitioner, Texas Eastern Transmission Corporation.

Dated at Houston, Texas, this 8th day of February, 1965.

[fol. 70] Certificate of Service Omitted in printing.

[fol. 71] [File endorsement omitted.]

[fol. 72] IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 22031

NATURAL GAS PIPELINE COMPANY OF AMERICA, Petitioner,

v.

FEDERAL POWER COMMISSION, Respondent.

MOTION OF NATURAL GAS PIPELINE COMPANY OF AMERICA TO WITHDRAW APPEAL EXCEPT AS TO PARTICULAR ISSUES, TO SEVER RETENTION OF REFUND ISSUE AND TO POSTPONE PROCEEDINGS AS TO SEVERED ISSUE—filed February 12, 1965.

To The Honorable Judges of the United States Court of Appeals For the Fifth Circuit:

Natural Gas Pipeline Company of America (Natural) hereby moves that the first four "Grounds For Review" in Natural's "Petition For Review" herein be withdrawn, that its appeal herein be maintained as to the fifth and sixth grounds therein, but that the sixth ground be severed from the fifth ground and that the schedule for the filing of briefs and other proceedings with respect to such sixth ground be postponed. In support thereof, Natural states:

[fol. 73] I. Motion to Withdraw the First Four Grounds of Appeal

Natural moves this Court to permit the withdrawal of its above-captioned appeal except as such appeal relates to the issues of (1) the use by the Commission of a consolidated effective tax rate rather than the applicable statutory tax rate in computing the Federal Income Tax Allowance in the jurisdictional cost of service of United Gas Pipe Line Company (United)* and (2) the Commission's ordering United to hold and retain refunds of amounts

* Assignment of Error (5) in Natural's Petition for Review.

which United's jurisdictional customers contend they are entitled to receive.**

As a jurisdictional pipeline customer of United, Natural filed its petition to review Opinion Nos. 428 and 428-A and accompanying orders issued by the Respondent, Federal Power Commission, relative to an application for rate increase filed by United in Docket No. RP63-1. Since the filing of the appeal, United, its customers (including Natural), and the Commission Staff have agreed to a settlement of various issues in United's Docket No. RP63-1 as well as a settlement of issues in rate increase proceedings filed by United in Docket Nos. RP61-18 and RP65-1. This settlement agreement disposed of all of the issues in the pending appeals filed in this Court by Natural, United, and the other pipelines with respect to the Commission's orders [fol. 74] in United's Docket No. RP63-1 except the two issues enumerated above. By order issued December 23, 1964, the Respondent, Federal Power Commission, approved the settlement agreement and ordered the appeals to be withdrawn except insofar as they relate to the two issues reserved by the settlement agreement. Natural therefore requests permission to withdraw the first four Grounds of Review in its Petition for Review herein, each of which relate to cost allocation, rate zone and rate design issues, each of which issues was settled by the above proceedings.

II. Motion to Sever Natural's Ground Number 6 for Review from Ground Number 5 and to Postpone Proceedings as to Ground Number 6

Natural further moves this Court to sever the issue of the Commission's attempts to order United to hold refunds due to its customers (Ground for Review Number 6) from the issue of rate treatment of "consolidated taxes" (Ground for Review Number 5) and to postpone the filing of briefs *** and other proceedings with respect to the refund retention issue.

** Assignment of Error (6) in Natural's Petition for Review.

*** Briefs of Natural and other petitioners are due on March 8, 1965.

In its order of December 23, 1965, approving the aforementioned settlement in United's Docket Nos. RP61-18, RP63-1 and RP65-1 the Commission, as in its prior orders in Docket No. RP63-1 ordered United to hold and retain, pending further order of the Commission, certain refunds [fol. 75] which Natural contends are legally and equitably due to United's customers. In accordance with Section 1.34 of the Commission's Rules of Practice and Procedure and Section 19(a) of the Natural Gas Act, Texas Eastern Gas Transmission Company has filed an Application for Rehearing of the Commission's order of December 23, 1964, insofar as it directs United to hold and retain certain refunds due Texas Eastern pending further order of the Commission.

That Application for Rehearing urges, *inter alia*, basically the same errors relative to the Commission ordering the retention of refunds by United as are urged in Natural's pending appeal in No. 22031 (Assignment of Error (6)). Texas Eastern's Application for Rehearing is presently pending before the Commission. If it is granted the refund issue in the pending appeals of Texas Eastern and Natural will be rendered moot. If the Application for Rehearing is denied, Texas Eastern has stated that it intends to file a petition for review in this Court which will necessarily duplicate in large part its present appeal in No. 22041, insofar as the retention of refunds by United is concerned, and Natural's Ground for Appeal Number 6.

Therefore, if Texas Eastern's pending Application for Rehearing is granted, the severance and postponement proposed herein will avoid burdening the Court and the parties with lengthy briefs, arguments, etc. related to an issue which will be moot. On the other hand if the pending Application for Rehearing is denied, the procedure pro- [fol. 76] posed by Natural herein will avoid the duplication of briefs, arguments, etc. which would result if the refund retention issue raised in the present appeals of Natural and Texas Eastern proceed now so that they are heard prior to the appeal of Texas Eastern from such denial.

Natural proposes to proceed with its appeal of the consolidated income tax issue in accordance with the procedures previously agreed upon and ordered by this Court and to file its initial brief on such issue with the Court in ac-

cordance with the heretofore filed stipulations of the parties and the orders of this Court.

Natural is authorized to inform the Court that the Respondent, Federal Power Commission, has no objection to the granting of this motion.

WHEREFORE Petitioner respectfully prays that this Court enter an order:

(1) Permitting Natural to withdraw and dismiss its appeal in No. 22031 except as such appeal relates to the consolidated tax issue and the refund retention issue as detailed above;

(2) Severing the refund retention issue from the consolidated tax issue and postponing proceedings with respect to such refund retention issue pending further proceedings in connection with Texas Eastern's Application for Rehearing of the Commission's order issued December 23, 1964 in Docket Nos. RP61-18, RP63-1 and RP65-1; and

[fol. 77] (3) Granting Natural such other and further relief as may to the Court appear to be just and equitable.

Respectfully submitted, /s/ William W. Brackett, Charles C. McDugald, William W. Brackett, Ross, Hardies, O'Keefe, Babcock, McDugald & Parsons Room 1900, 122 South Michigan Avenue, Chicago, Illinois 60603, Attorneys for Petitioner, Natural Gas Pipeline Company of America.

February 10, 1965.

[fol. 78] [File endorsement omitted]

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 21872

UNITED GAS PIPE LINE COMPANY, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

No. 21958

UNITED GAS PIPE LINE COMPANY, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

No. 22031

NATURAL GAS PIPE LINE COMPANY OF AMERICA, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

[fol. 79] No. 22039

TEXAS GAS TRANSMISSION CORPORATION, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

No. 22041

TEXAS EASTERN TRANSMISSION CORPORATION, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

PETITIONS FOR REVIEW OF ORDERS OF THE FEDERAL POWER COMMISSION

ORDER GRANTING MOTIONS—Filed March 3, 1965

Before TUTTLE, Chief Judge, and BROWN and FRIENDLY*, Circuit Judges.

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* Of the Second Circuit, sitting by designation.

By the Court:—

It Is Ordered that the Motion of Petitioner in Case Nos. 21872 and 21958 for leave to withdraw and abandon certain issues in said causes be, and the same is hereby Granted;

It Is Further Ordered that the Motions of Petitioners in Case Nos. 22031 and 22041 to withdraw appeal except as to particular issues, to sever retention of refund issue, and to postpone proceedings as to severed issue in said causes be, and the same are hereby Granted;

[fol. 80] It Is Further Ordered that the Motion of Petitioner in Case No. 22039 to withdraw its Petition for Review be, and the same is hereby Granted; and

It Is Further Ordered that the Motion of Intervenor, Willmut Gas and Oil Company, for leave to withdraw as Intervenor in Case Nos. 21872, 21958, 22039 and 22041 be, and the same is hereby Granted.

[fol. 81] IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 21872

UNITED GAS PIPE LINE COMPANY, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

No. 21958

UNITED GAS PIPE LINE COMPANY, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

No. 22031

NATURAL GAS PIPE LINE COMPANY OF AMERICA, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

No. 22041

TEXAS EASTERN TRANSMISSION CORPORATION, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

[fol. 82] Petitions for Review of Orders of the Federal Power Commission

OPINION—February 10, 1966.

Before JONES, WISDOM and GEWIN, Circuit Judges.

PER CURIAM: Before the Court for its consideration are four petitions for review of orders of the Federal Power Commission which present the same rather narrow but difficult question for determination. The Petitioner United Gas Pipe Line Company is a natural gas transmission company. It is a member of an affiliated group which files consolidated Federal income tax returns, and its income is included in the consolidated returns. If United had not joined in the filing of consolidated returns, but had filed re-

turns only reporting its income for tax computation, its net taxable income would have been fixed at a 52% rate. Because another of the affiliated companies, which is not subject to Federal Power Commission jurisdiction, sustained losses, the tax rate for the consolidated group is less than 52%.[1] United claimed that in fixing its rates, the Commission should allow as a part of cost of service the amount of income tax which it would have paid if it had filed a separate income tax return. The Commission disagreed. It allocated the tax differential between the 52% rate and the rate paid on the consolidated return, and allowed what it called an effective tax rate. The reasoning and conclusions of the Commission in *Re Cities Service Gas Co.*, 30 F.P.C. 158, 49 P.U.R. 3d 229, were followed by the [fol. 83] Commission. The Commission, with two of the Commissioners dissenting, rejected the contention of United. *Re United Gas Pipe Line Company*, ... F.P.C. . . . ., 54 P.U.R. 3d 285.[2] United has petitioned for a review of the Commission's order. Texas Gas Transmission Corporation and Texas Eastern Transmission Corporation, who are customers of United and intervenors in the proceeding before the Commission, have also petitioned for review, aligning themselves with United.[3]

The Court of Appeals for the Tenth Circuit vacated the Commission's order in the *Cities Service* case. *Cities Service Gas Co.* v. *Federal Power Commission*, 10th Cir. 1964, 337 F.2d 97. United would have us follow the Tenth Circuit's *Cities Service* decision. The Commission says that the *Cities Service* case is to be distinguished because of

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[1] The 52% corporate tax rate referred to here and elsewhere is not strictly accurate as the first $25,000 of corporate income is taxed at a 22% rate.

[2] Subsequent rulings of the Commission, ... F.P.C. . . . ., 55 P.U.R. 3d 483, ... F.P.C. . . . ., 55 P.U.R. 3d 499, on rehearings do not affect its ruling on the issue before the Court.

[3] The Commission has suggested that these intervenors are not aggrieved by the order and hence have no standing to seek a review of the order. The Court's disposition of the cause makes unnecessary a determination of this question.

fact differences. It urges that the Tenth Circuit decision is wrong and should not be followed. We do not think there are any such fact differences between *Cities Service* and this case as call for the application of any different rule of decision. The Court in the Tenth Circuit case held that the tax allocation as made by the Commission's order was contrary to the requirements which Congress had imposed. We think the Tenth Circuit case is correct and that the principles which are announced in its opinion are here applicable and controlling. The Commission's order, using an incorrect [fol. 84] income tax rate in computing cost of service for the fixing of United's gas rates is erroneous and must be

VACATED AND SET ASIDE.

[fol. 85] IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

OCTOBER TERM, 1965

D. C. No. RP63-1

No. 21872

UNITED GAS PIPE LINE COMPANY, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

No. 21958

UNITED GAS PIPE LINE COMPANY, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

No. 22031

NATURAL GAS PIPE LINE COMPANY OF AMERICA, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

No. 22041

TEXAS EASTERN TRANSMISSION CORPORATION, Petitioner,

versus

FEDERAL POWER COMMISSION, Respondent.

[fol. 86] Petitions for Review of Orders of the Federal Power Commission

Before JONES, WISDOM and GEWIN, Circuit Judges.

JUDGMENT—February 10, 1966

This cause came to be heard on the petitions of United Gas Pipe Line Company, Natural Gas Pipe Line Company of America and Texas Eastern Transmission Corporation, for review of Orders of the Federal Power Commission, on the consolidated tax issue, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the Order of the

Federal Power Commission in this cause be, and the same is hereby vacated and set aside in accordance with the opinion of this Court.

Issued as Mandate: Mar. 7, 1966.

[fol. 87] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 88] SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1965

No. 1301

FEDERAL POWER COMMISSION, Petitioner,

v.

UNITED GAS PIPE LINE COMPANY, ET AL.

ORDER ALLOWING CERTIORARI—June 13, 1966

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit is granted. The case is consolidated with No. 1302 and a total of two hours is allotted for oral argument.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Fortas took no part in the consideration or decision of this petition.

[fol. 89] SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1965

No. 1302

MEMPHIS LIGHT, GAS AND WATER DIVISION, Petitioner,

v.

UNITED GAS PIPE LINE COMPANY, ET AL.

ORDER ALLOWING CERTIORARI—June 13, 1966

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit is granted. The case is consolidated with No. 1301 and a total of two hours is allotted for oral argument.

And it is further ordered that the duly certified copy of the transcript of the proceedings below, which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Fortas took no part in the consideration or decision of this petition.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1966—238-976/57

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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. ———

FEDERAL POWER COMMISSION, PETITIONER

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, AND TEXAS EASTERN TRANSMISSION CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the Federal Power Commission, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case entered on February 10, 1966.

OPINIONS BELOW

The opinion of the court of appeals (App A, *infra*, pp. 18–20) is reported at 357 F. 2d 230. The opinion and order of the Federal Power Commission are reported at 31 F.P.C. 1180 (II R. 32–55; see II R. 41–42, 31 F.P.C. at 1190–1191, for the relevant portions). The Commission's decisions on the applications for rehearing are reported at 32 F.P.C. 687, 879, and 1163.

JURISDICTION

The judgment of the court of appeals setting aside the Commission's order was entered on February 10, 1966 (App. B, *infra*, pp. 21–22). We invoke the jurisdiction of this Court under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether, in fixing the rates charged by a natural gas company, the Federal Power Commission must allow as a cost of service the amount of federal income taxes the company would have paid if it had filed a separate tax return, when in fact it filed a consolidated return with affiliated corporations (not all the operations of which are subject to the Commission's regulatory jurisdiction), resulting in a net tax savings for the group of affiliates.

STATUTES INVOLVED

The Natural Gas Act, June 21, 1938, c. 556, 52 Stat. 821–833, as amended, 15 U.S.C. 717–717w, provides in pertinent part:

> SEC. 4. (d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. * * *

(e) Whenever any such new schedule is filed the Commission shall have authority * * * to enter upon a hearing concerning the lawfulness of such rate * * *. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company * * *.

The Internal Revenue Code of 1954, 68A Stat. 3, *et seq.*, as amended, 26 U.S.C. 1–8023, provides in pertinent part:

§ 1501. Privilege to file consolidated returns

An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. * * *

* * * * *

§ 1504. Definitions

(a) Definitions of "affiliated group".—As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

* * * * *

STATEMENT

1. THE FACTS

United Gas Pipeline Company (United) is a major interstate natural gas pipeline company subject to the jurisdiction of the Federal Power Commission.[1] It is a wholly owned subsidiary of United Gas Corporation (Gas Corporation). The latter's principal business is the operation of several local gas distribution systems (which are subject to State and municipal rate regulation) in Texas, Louisiana and Mississippi. Gas Corporation also owns all the stock of Union Producing Company (Union), a domestic producer of oil and gas whose interstate gas sales are subject to Federal Power Commission regulation, and United Overseas Production Corporation, which is engaged in foreign oil exploration.

[1] Approximately 44 percent of United's sales are within the rate jurisdiction of the Commission (R. 54).

Union, United and Gas Corporation constitute an integrated gas utility system from wellhead to consumer's premises, with Union selling approximately 80 percent of the gas it produces to United and United furnishing Gas Corporation (the distributing arm of the system) with approximately 96 percent of the latter's gas.[2] With gross revenues in 1961 of $298 million, United is by far the largest company in the system; in the same year, Gas Corporation's gross operating revenues were $50 million and Union's $52 million.[3]

Gas Corporation and its wholly owned subsidiaries, including United, file (pursuant to Section 1501 of the Internal Revenue Code of 1954, see p. 3, *supra*) consolidated federal income tax returns in which the taxable transactions of the four members of the affiliated group are combined to produce a single net taxable income, upon which the tax is computed. Any tax losses sustained during the taxable period by a member of the group are offset against the taxable income of the profit companies for the same period in determining the consolidated net taxable income, and income and expense items resulting from transactions among the affiliates are excluded in computing the taxable income of the consolidated group.[4]

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[2] *Union Producing Co.*, 31 F.P.C. 41, 43–44; 1964 Annual Report of United Gas Corporation, p. 4 (on file with FPC).

[3] Moody's Public Utility Manual (1962), p. 1368.

[4] Thus, dividends paid by affiliates are excluded from the income of the receiving company; and interest paid to affiliates is treated as income to the receiving company and a deduction to the paying company, and so cancel out (R. 93).

Between 1957 and 1961, the group, filing consolidated returns, paid $57,199,881 to the government in income (excluding capital-gains) taxes (R. 53). Had separate returns been filed, the total tax for the four companies for the same period (excluding the taxes that would have been paid on inter-company dividends)[5] would have been $59,291,919. The difference reflects the fact that in the consolidated returns the group was able to set off Union's net tax losses of $3,869,626, and the $24,434 loss of Overseas (which commenced operations in 1961, see R. 24), against the income of United and Gas Corporation.

2. PROCEEDINGS BELOW

On June 15, 1962, United,[6] pursuant to Section 4(d) of the Natural Gas Act (p. 2, *supra*), filed revised schedules with the Federal Power Commission increasing its rates overall. The Commission ordered a hearing to determine the lawfulness of the increased

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[5] Prior to 1964, 15 percent of all dividends received by corporations were taxable as ordinary income, so that where inter-affiliate dividends were large the tax savings to the consolidated group in this respect alone were substantial. During the five-year period, Gas Corporation received $66,567,028 in dividends from United and Union, on which a tax of about $5 million would have been due had separate returns been filed. Section 214 of the Revenue Act of 1964 permits the exclusion of 100 percent of dividends received from 80-percent-owned affiliates. 78 Stat. 52, 26 U.S.C. 243.

[6] The other respondents in this Court are pipeline customers of United that intervened before the Commission and participated in the review proceeding in the court of appeals, opposing this reduction in United's rates. They each join with their affiliates in filing consolidated tax returns.

rates, and, in its decision of May 14, 1964 (31 F.P.C. 1180, II R. 32), made the reduction here involved. In petitioning for review below United objected to this and other aspects of the Commission's order, but, by the time the case was decided, only one issue remained: whether the Commission could test the reasonableness of United's rates against its cost of service without including in such cost the full amount of federal income taxes United would pay if it paid at the standard rate for corporate taxpayers filing separate returns, when, in fact, United joins in consolidated returns that produce substantial savings.

The Commission's approach was as follows. Applying principles that it had recently enunciated in its *Cities Service* decision, 30 F.P.C. 158, later set aside in *Cities Service Gas Co.* v. *Federal Power Commission,* 337 F. 2d 97 (App. C, pp. 23–30, *infra*), it held (II R. 41–42) that, in order fairly to apportion the joint federal income tax costs, "the fundamental rate making principle" that "requires a separation between regulated and unregulated costs and revenues" should be recognized (30 F.P.C. at 162). To this end it (1) separated the affiliated corporations into regulated and unregulated groups; (2) determined the net taxable income (after deducting any losses) of each group; and (3) apportioned the total consolidated tax liability over a representative period of time between the two groups, and then among the companies in the regulated group, in proportion to their

respective taxable incomes (II R. 41).[7] This meant that any losses sustained by any unregulated company or activity would first be set off against the total income of all the unregulated operations. Since, however, here the unregulated activities produced no net taxable income during the five-year period 1957–1961 (used by the Commission as a representative test period), this preliminary step became unnecessary. The consolidated tax actually paid by the system during the test period was simply allocated between the two profit companies, Gas Corporation and United, in proportion to their taxable incomes (excluding capital gains) for the five years—$9,024,170 and $105,290,983, respectively.

United's income was 92.11 percent of the total. This percentage was multiplied by the system's average annual tax of $11,439,976 during the test period, producing a sum ($10,537,362) deemed by the Commission to be United's fair share of the tax. This sum represented 50.04 percent of United's average annual taxable income of $21,058,197. It was this effective tax rate—not the 52-percent rate at which United would have paid federal income tax had it filed a separate return—that the Commission used to determine United's test-year tax allowance for rate purposes (II R. 41, 42 53).

United contended that it was entitled to compute its tax allowance for rate-making purposes at the

[7] The Commission added that in no event should "the allowance so computed for the regulated company * * * exceed what its tax liability would be for rate making purposes, if computed on a separate return basis." (30 F.P.C. at 164.)

separate-return rate, and the court of appeals agreed. In a brief opinion (App. A, *infra*, pp. 18–20) it adopted the reasoning on this issue of the Tenth Circuit in *Cities Service Gas Co.* v. *Federal Power Commission*, 337 F. 2d 97 (printed in App. C, *infra*, pp. 23–30). Neither court addressed itself to the particulars of the Commission's allocation method—the three-step procedure described above. Both apparently concluded that the Commission was powerless to make any allocation and that United was entitled to have federal income tax included in the cost of service used to test the reasonableness of its rates at the full 52-percent rate for separate corporate returns.

REASONS FOR GRANTING THE WRIT

Taxes incurred by a public utility are normally treated as a part of its cost of service against which the reasonableness of its rates is tested. In the present case the utility (a natural-gas pipeline company regulated by the Federal Power Commission) did not file a separate federal income tax return. Rather, it filed a consolidated return as part of a group of affiliated corporations. While United (the respondent pipeline company) had taxable income, some of the other members of the group—companies engaged in oil and gas production—did not. The filing of consolidated returns permitted the tax losses of the producing companies to be offset against United's income, resulting in a smaller tax for the group than if each member had filed a separate return. United claimed, however, that it was entitled to include in its cost of service a tax allowance equal to the larger tax that

it would have paid had it filed separately—this on the theory that no part of the tax saving due to the consolidated filing should be attributed to it. The court below, following an earlier decision of the Tenth Circuit (*Cities Service Gas Co.* v. *Federal Power Commission*, 337 F. 2d 97, App. C, *infra*, pp. 23–30), upheld this contention, denying that the Commission has any power to compel an allocation of the tax saving. We believe that this ruling is erroneous and that the question is in all events one of substantial importance in the administration of the Commission's rate-making responsibilities.

1. We emphasize at the outset the breadth of the ruling below. The court of appeals did not criticize the particular allocation formula applied by the Commission (see Statement, *supra*, pp. 7–8); it apparently held that the Commission is powerless to allocate under *any* formula—at least in a case like the present where some of the activities of the consolidated group that give rise to the tax losses are outside the regulatory regime of the Commission.[8] The court of appeals' view would have considerable force if there were no rational connection between the regulated and

[8] There may indeed be problems in the application of the particular formula used by the Commission in this case, a formula which may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group. These problems need not be faced here, however, since, as noted in the text, the disagreement of the court below was not with the details of the allocation method but with the principle that allocation is under any method permissible.

unregulated activities of the consolidated group whose tax saving the Commission sought to allocate. But there clearly is such a connection.

It is axiomatic that there can be no tax savings without profits. A tax loss does not in itself automatically give rise to a benefit; that occurs only when there are profits against which to offset the loss. In the present case, the regulated companies in the affiliated group—United (the pipeline company) and Gas Corporation (the distributing company)—supplied the profits that permitted the producing companies' losses to be turned into an immediate tax saving for the consolidated group.[9] In this connection, it is highly material that, as regulated quasi-monopolistic utilities, respondent and Gas Corporation have virtually assured profit positions. An affiliated group of corporations that includes a pipeline of United's magnitude is virtually certain to have a steady source of profits against which to offset losses from other ventures—a factor which guarantees that any tax losses will give rise to tax savings and furnishes a substantial cushion against entrepreneurial risks. Thus, it is clear that any tax savings that result from the consolidated computation are at least partly at-

[9] A tax loss of a corporation filing a separate return can only be carried back three years or forward five (26 U.S.C. 172); it cannot be offset against the income of another corporation. Hence, where separate returns are filed, the reaping of any tax benefit from a loss depends on the existence of profits adequate to absorb the loss within the prescribed time limits; where consolidated returns are filed, tax losses may be translated immediately into tax savings irrespective of the past or future profitability of the tax loss company.

tributable to the fully regulated members of the group.[10]

As one would expect in a closely integrated system, the pipeline and distribution companies contribute importantly to the production arm of the business in other respects as well. A large and profitable system can raise capital on favorable terms.[11] Moreover, in a vertically integrated enterprise, the production company has an assured market. Here, of course, there was the further assurance that Union's rates to United would be fixed so as to cover its cost of service, including a fair return on investment (unless its costs proved so excessive as to be improvident). These costs would therefore be borne ultimately by United's customers. It is thus wholly unrealistic to attribute tax savings dependent upon tax losses sustained by the members of the group engaged in unregulated activities solely to those members, ignoring the important contribution made by the fully regulated members—and their customers. Such tax savings should be regarded as reducing the joint tax costs

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[10] In addition, of course, respondent's participation in the joint return filed by the group was an inescapable statutory prerequisite to any of its members' taking advantage of the consolidated tax treatment provided by Section 1501 of the Internal Revenue Code. For, under that section, in order for an affiliated group of companies to qualify to file a consolidated return every subsidiary in which the parent owns 80 percent or more of the stock must join.

[11] Union's entire capital was furnished by Gas Corporation. *Union Producing Co.*, 31 F.P.C. 41, 47. The problems and risks for an unaffiliated producer are greater. See discussion in *Southern Natural Gas Co.*, 29 F.P.C. 323, 336.

of the consolidated group and, like any other reduction in joint costs, allocated among the members of the group by an appropriate method. Compare *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581.

2. The view of the court below—that the Commission lacks power to allocate, for rate-making purposes, the tax savings generated by the filing of a consolidated return—finds no support in the policy underlying the relevant provisions of the Internal Revenue Code. The purpose of permitting the filing of a consolidated return is not to confer a benefit upon the loss company alone—the result reached below—but to recognize the business reality that affiliated corporations constitute a single entity no less than if the affiliates were divisions of a single corporation. See S. Rep. No. 960, 70th Cong., 1st Sess., p. 14; H. Rep. No. 704, 73d Cong., 2d Sess., p. 17; *Erie Lighting Co.* v. *Commissioner of Internal Revenue*, 93 F. 2d 883, 884–885 (C.A. 1). There is no indication that Congress, by thus permitting the corporate form to be disregarded for some tax purposes, proposed to preclude allocation of the resulting tax savings among the members of the consolidated group; all indications, indeed, are to the contrary.[12]

As a matter of fact, the Commission has long offset the tax losses of a natural gas pipeline company's production department resulting from its gas opera-

[12] "* * * The Code and Regulations recognize that the benefit of consolidated returns is for all corporations in the group. Any subsidiary in the group, as well as the parent, may pre-

tions against the larger tax liability that would otherwise have been incurred by the pipeline company as a result of its profitable transmission operations. See, *e.g.*, *El Paso Natural Gas Co.* v. *Federal Power Commission*, 281 F. 2d 567, 571–573 (C.A. 5), certiorari denied *sub nom. California* v. *Federal Power Commission*, 366 U.S. 912. Respondent has not challenged this principle. But if that is sound, surely it would be anomalous, and contrary to the scheme of the relevant Code provisions, for the pipeline company to be able to achieve different treatment merely by incorporating the production department as a separate subsidiary.

3. Since the Court of Appeals for the Tenth Circuit has adopted the same view as the court below (*Cities Service Gas Co.* v. *Federal Power Commission*, *supra*), and since so many of the principal companies subject to the Commission's rate juris-

---

vent the filing of consolidated returns if the filing is detrimental or contrary to the interests of such corporation. * * *

* * * * *

"There is nothing in the Code or Regulations that compels the conclusion that a tax saving must or should inure to the benefit of the parent company or of the company which has sustained the loss that makes possible the tax saving." *Western Pacific R.R. Corp.* v. *Western Pacific R. Co.*, 197 F. 2d 994, 1003–1004 (C.A. 9), reversed on procedural grounds, 345 U.S. 247, but see Justice Jackson, dissenting, who would have affirmed on the merits, 345 U.S. at 277.

Cf. Section 1552 of the Internal Revenue Code, which prescribes a number of alternative methods of allocating the consolidated tax among the members for earnings and profits purposes.

diction are able to invoke the reviewing jurisdiction of at least one of these two courts of appeals, the decision below, unless reversed, will, as a practical matter, prove conclusive for the entire industry.

The issue is undeniably a very substantial one from the standpoint of the nation's consumers of natural gas. Of the 77 pipeline companies having annual utility operating revenues of $1 million or more, 39 reported to the Commission in 1964 that they participated in consolidated returns; presumably the motive in each case was tax savings. Each such instance raises the question whether the consumer shall share in these savings or whether he shall be required to pay rates which reimburse the pipeline company as if such savings had not been effectuated.

In addition, the question presented by this case has ramifications throughout the field of public utility regulation. Thus, the principles of this case appear fully applicable to electric companies regulated by the Commission under the Federal Power Act, 16 U.S.C. 791a–825r. Sixty-one of the major electric utilities reported to the Commission in 1964 that they participated in the filing of consolidated returns. The same issue involved in the present case arises under Part II of the Communications Act of 1934, 47 U.S.C. 201–222; it has been the practice of the FCC to take into account any tax savings resulting from the filing of consolidated returns in computing a regulated carrier's tax allowance. *Investigation of Rates and Charges to West Indies,* 10 F.C.C. 33, 51–53; see, also, *Western*

Union Telegraph Company, 25 F.C.C. 532, 648, Table A, n. 2. There are also numerous decisions by State courts and commissions dealing with the federal income tax component to be utilized in determining the rates of telephone, water, electric, gas, and other utilities filing consolidated returns with other companies,[13] and while a decision by this Court in the present case would not bind the State authorities it would undoubtedly be influential.

The problem, in short, is one of major concern in the regulatory community, and its resolution will affect by many millions of dollars the rates to be paid by members of the public for various types of utility service.

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[13] See, *e.g.*, *Arkansas-Louisiana Gas Co.* v. *City of Texarkana, Ark.*, 17 F. Supp. 447 (W.D. Ark.); *Re Southwestern Bell Telephone Company*, 2 P.U.R. 3d 1, 17 (Ark.); *Re Chesapeake & Potomac Telephone Company*, 6 P.U.R. 3d 222, 242–244 (D.C.); *Re United Fuel Gas Company*, 8 P.U.R. 3d 340, 346–347 (Ky.); *Re Chesapeake & Potomac Telephone Company of Baltimore City*, 5 P.U.R. 3d 161, 166–168 (Md.); *Re New Jersey Bell Telephone Company*, Docket No. 7519, XVIII Reports of the New Jersey Board of P.U.C. 562; *Re New Jersey Bell Telephone Company*, 24 P.U.R. 3d 181, 195 (N.J.); *Re Northwestern Bell Telephone Company*, 2 P.U.R. 3d 93, 95 (N. Dak.); *Riverton Consolidated Water Company* v. *Pennsylvania Public Utility Commission*, 24 P.U.R. 3d 9, 20–21 (Pa. Super. Ct.).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.
RALPH S. SPRITZER,
RICHARD A. POSNER,
Assistants to the Solicitor General.

RICHARD A. SOLOMON,
General Counsel,
HOWARD E. WAHRENBROCK,
Solicitor,
CYRIL S. WOFSY,
Attorney,
Federal Power Commission.

MAY 1966.

APPENDIX A

In The United States Court of Appeals for the Fifth Circuit

No. 21872

UNITED GAS PIPE LINE COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

No. 21958

UNITED GAS PIPE LINE COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

No. 22031

NATURAL GAS PIPE LINE COMPANY OF AMERICA, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

No. 22041

TEXAS EASTERN TRANSMISSION CORPORATION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

PETITIONS FOR REVIEW OF ORDERS OF THE FEDERAL POWER COMMISSION.

(February 10, 1966)

Before JONES, WISDOM and GEWIN, *Circuit Judges.*

Per Curiam: Before the Court for its consideration

are four petitions for review of orders of the Federal Power Commission which present the same rather narrow but difficult question for determination. The Petitioner United Gas Pipe Line Company is a natural gas transmission company. It is a member of an affiliated group which files consolidated Federal income tax returns, and its income is included in the consolidated returns. If United had not joined in the filing of consolidated returns, but had filed returns only reporting its income for tax computations, its net taxable income would have been fixed at a 52% rate. Because another of the affiliated companies, which is not subject to Federal Power Commission jurisdiction, sustained losses, the tax rate for the consolidated group is less than 52%.[1] United claimed that in fixing its rates, the Commission should allow as a part of cost of service the amount of income tax which it would have paid if it had filed a separate income tax return. The Commission disagreed. It allocated the tax differential between the 52% rate and the rate paid on the consolidated return, and allowed what it called an effective tax rate. The reasoning and conclusions of the Commission in *Re Cities Service Gas Co.*, 30 F.P.C. 158, 49 P.U.R. 3d 229, were followed by the Commission. The Commission, with two of the Commissioners dissenting, rejected the contention of United. *Re United Gas Pipe Line Company*, * * * F.P.C. * * *, 54 P.U.R. 3d 285.[2] United has petitioned for a review of the Commission's order. Texas Gas Transmission

[1] The 52% corporate tax rate referred to here and elsewhere is not strictly accurate as the first $25,000 of corporate income is taxed at a 22% rate.

[2] Subsequent rulings of the Commission, —— F.P.C. ——, 55 P.U.R. 3d 483, —— F.P.C. ——, 55 P.U.R. 3d 499, on rehearings do not affect its ruling on the issue before the Court.

Corporation and Texas Eastern Transmission Corporation, who are customers of United and intervenors in the proceeding before the Commission, have also petitioned for review, aligning themselves with United.[3]

The Court of Appeals for the Tenth Circuit vacated the Commission's order in the *Cities Service* case. *Cities Service Gas Co.* v. *Federal Power Commission*, 10th Cir. 1964, 337 F. 2d 97. United would have us follow the Tenth Circuit's *Cities Service* decision. The Commission says that the *Cities Service* case is to be distinguished because of fact differences. It urges that the Tenth Circuit decision is wrong and should not be followed. We do not think there are any such fact differences between Cities Service and this case as call for the application of any different rule of decision. The Court in the Tenth Circuit case held that the tax allocation as made by the Commission's order was contrary to the requirements which Congress had imposed. We think the Tenth Circuit case is correct and that the principles which are announced in its opinion are here applicable and controlling. The Commission's order, using an incorrect income tax rate in computing cost of service for the fixing of United's gas rates is erroneous and must be

Vacated and set aside.

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[3] The Commission has suggested that these intervenors are not aggrieved by the order and hence have no standing to seek a review of the order. The Court's disposition of the cause makes unnecessary a determination of this question.

APPENDIX B

United States Court of Appeals for the Fifth Circuit
October Term, 1965
D.C. No. RP63–1

No. 21872

UNITED GAS PIPE LINE COMPANY, PETITIONER
v.
FEDERAL POWER COMMISSION, RESPONDENT

No. 21958

UNITED GAS PIPE LINE COMPANY, PETITIONER
v.
FEDERAL POWER COMMISSION, RESPONDENT

No. 22031

NATURAL GAS PIPE LINE COMPANY OF AMERICA, PETITIONER
v.
FEDERAL POWER COMMISSION, RESPONDENT

No. 22041

TEXAS EASTERN TRANSMISSION CORPORATION, PETITIONER
v.
FEDERAL POWER COMMISSION, RESPONDENT

PETITIONS FOR REVIEW OF ORDERS OF THE FEDERAL POWER COMMISSION

Before JONES, WISDOM and GEWIN, *Circuit Judges*

JUDGMENT

This cause came to be heard on the petitions of United Gas Pipe Line Company, Natural Gas Pipe

Line Company of America and Texas Eastern Transmission Corporation, for review of Orders of the Federal Power Commission, on the consolidated tax issue, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the Order of the Federal Power Commission in this cause be, and the same is hereby vacated and set aside in accordance with the opinion of this Court.

February 10, 1966.

Issued as Mandate: March 7, 1966.

EDWARD W. WADSWORTH,
U.S. Court of Appeals, Fifth Circuit.
By ——— ———,
Deputy.

APPENDIX C

United States Court of Appeals, Tenth Circuit

July Term—1964

No. 7538

Filed, United States Court of Appeals, Tenth Circuit, October 9, 1964.

CITIES SERVICE GAS COMPANY AND CITIES SERVICE COMPANY, PETITONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

ON PETITION TO REVIEW AN ORDER OF THE FEDERAL POWER COMMISSION

Harry S. Littman (Conrad C. Mount, Jack Werner, George H. Hill, Jr., Melvin Richter and Richard Littell with him on brief) for Petitioners.

Richard A. Solomon (Howard E. Wahrenbrock, Abraham R. Spalter and Cyril S. Wofsey with him on brief) for Respondent.

Before MURRAH, *Chief Judge, and* HILL, *Circuit Judge,* and ARRAJ, *District Judge*

MURRAH, *Chief Judge.*

In an order of the Federal Power Commission approving a settlement of the rates charged by Cities Service Gas Company for jurisdictional gas sales, the Commission reserved for future determination the Federal income tax allowance to be included in the cost of service underlying the approved settlement.

This appeal is from a final order of the Commission determining that sole issue.

The stipulated settlement included as a part of the cost of service a tax allowance based upon the statutory corporate income tax rate of 52 percent applied to the agreed taxable income of the Gas Company for the test year 1958. And, that amount would be routinely granted as a cost of service but for the Gas Company's participation in consolidated returns filed by its parent, Cities Service Company.

Having elected to file consolidated returns under Section 1501, 26 U.S.C., Cities Service was required by Section 1504, 26 U.S.C., to include all affiliates in which it owns 80 percent or more of the stock. Under the consolidated returns the total tax liability was less than it would have been if each subsidiary had filed separate returns. The reduction in the total tax liability resulted from offsetting the losses incurred by certain nonregulated affiliates against the taxable income of all other affiliates; and the Commission determined a tax allowance which reflected the so-called "tax savings" effected by the consolidated returns. The decisive question is whether the Commission, in the exercise of its undoubted power to determine just and reasonable rates for jurisdictional gas sales, may, in these circumstances, take into account the losses of nonregulated and unrelated affiliates to calculate the tax allowance includible in the cost of service of a regulated company.

The Commission recognized the fundamental ratemaking principle which requires a separation of regulated and nonregulated profits and losses in the determination of the tax allowance. And see *Colorado Interstate Gas Co.* v. *F.P.C.*, 324 U.S. 581; *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 324 U.S. 635. In obedience to this principle, the majority of

the Commission rejected its Staff's theory which determined the tax allowance by taking the ratio of the Gas Company's income to the total income of the profit-making companies and applying this percentage to the total tax liability. The Commission characterized this theory as possessing "a quality of artificiality and instability which renders it unsatisfactory for rate-making purposes."

The majority of the Commission also rejected the determinations and recommendations of its Examiner who discarded the Staff's theory in favor of the settlement allowance based upon the statutory 52 percent rate. The Examiner could find no authority to support the theory that "consumers of natural gas sold in interstate commerce should have the benefit of 'tax savings' derived from business losses of unregulated corporations whose business activities are entirely unconnected with and dissimilar to those of the regulated natural gas company transporting and selling such gas."

Proceeding on the established premise that only actual costs—hence actual taxes—are properly includible in a rate base, a majority of the Commission held that the consolidated income tax liability is the "only real cost which was incurred by Gas Company in conjunction with the other Cities Service affiliates," and that to accept the Gas Company's approach based upon the statutory 52 percent rate would have the effect of determining jurisdictional rates "on the basis of converting a hypothetical tax payment into a prudent operating expense."

To comply with the rate-making principal of separating regulated and nonregulated profits and losses, and in conformity with the equally controlling actual cost concept, the majority of the Commission devised a "method to be applied in computing the

Federal income taxes to be included in the cost of service of a regulated company where the company has joined in a consolidated tax return with affiliates * * * (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate-making purposes, if computed on a separate return basis."[1]

As the basis for the application of this formula, the majority first selected the consolidated returns filed for the years 1957, 1958 and 1959. After separating the affiliates into regulated and nonregulated groups, the Commission determined that during the pertinent period the nonregulated companies had no net taxable income and that no tax liability should therefore be assigned to that group. The total taxable income of the regulated affiliates, which included companies regulated by other Federal and State agencies,[2] was determined to be $61,652,662, of which the Gas Com-

[1] One Commissioner would have adopted the Staff's theory but reluctantly joined two Commissioners in applying the above-described method in order to form a working majority. The other two Commissioners dissented contending that the Examiner's recommendations should be adopted. The dissenters were of the opinion that "Apart from the fact that there are no tax savings attributable to the inclusion of Gas Company in the consolidated return, the majority view is unlawful because it has the effect of regulating nonutility enterprises beyond the Commission's jurisdiction."

[2] Included by the Commission in the so-called "regulated" group, in addition to the Gas Company, are Cities Service

pany's share was 67.93 percent. This percentage was then applied to the normalized consolidated tax liability of all affiliates, an average of $8,636,607 a year, to arrive at the tax allowance of $5,866,847. The stipulated settlement had provided for a tax allowance of $7,055,981 based upon the statutory rate of 52 percent of the net separate taxable income of the Gas Company in 1958. The difference between these two sums is the bone of contention.

We think it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent Company. This approach cannot be justified by the actualities of the case. The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52 percent rate, but its tax liability at that rate was reported to the parent Company, and the consolidated returns actually reflect that tax liability.

Thus the consolidated return for 1957 shows a consolidated tax liability of $12,251,639 paid by Cities Service. If the Gas Company had filed a separate return, the consolidated tax liability would have amounted to $6,391,241, and the Gas Company's tax would have been $5,860,398 based upon the statutory 52 percent rate. The sum of these amounts precisely equals that which was actually paid by Cities Service. From this it is demonstrably clear that the inclusion of the Gas Company in the consolidated return in-

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Pipe Line Co., and Lafitte Oil Traders, Inc., both subject to regulation by the Interstate Commerce Commission, and Kansas Gas Supply Company, subject to regulation by the Kansas Commission. Also included in this group is that portion of the income of Cities Service Gas Producing Co. and Cities Service Oil Co.—Delaware—subject to regulation by the Federal Power Commission. These companies, however, are primarily engaged in the wholly unregulated oil business.

creased the consolidated tax liability by 52 percent of the Gas Company's taxable income. No "tax savings" resulted from the inclusion of the Gas Company in the consolidated return.

Similarly, in both 1958 and 1959 the inclusion of the Gas Company in the consolidated returns directly affected the consolidated tax liability in the amount of 52 percent of the Gas Company's taxable income, notwithstanding the fact that in those years the other Cities Service affiliates had aggregate tax losses. Application of the loss carry-back provisions of the Internal Revenue Code permit the offsetting of these losses against the taxable income of these affiliates in 1955 and 1956 [3], thereby resulting in tax refunds. No reduction in the actual total tax liability was thus effected since the net effect of the inclusion of the Gas Company in the 1958 and 1959 consolidated returns was to reduce the refund by 52 percent of the Gas Company's taxable income. See table below.[4] The simple fact is that the tax liability of the Gas Company as reflected in the consolidated returns was not hypothetical, but an actual cost to the Gas company.

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[3] The regulations promulgated pursuant to § 1502, 26 U.S.C. provide in accordance with § 172, 26 U.S.C. that a net loss in any year can be carried back to the three preceding years or carried forward to the succeeding five years. 26 C.F.R. Part 1, § 1.1502-31(a)(4).

[4] See the following table:

Year	(1) Consolidated tax (including Gas Company)	(2) Consolidated tax (excluding Gas Company)	(3) Gas Company's separate tax	(4) Sum of (2) plus (3)
1957	$12,251,639	$6,391,241	$5,860,398	$12,251,639
1958	(3,857,132)	(10,224,666)	6,367,534	(3,857,132)
1959	2,965,014	(6,566,531)	9,531,545	2,965,014

We know, of course, that the Commission is free to choose most any method which it deems appropriate in the determination of just and reasonable rates for jurisdictional gas sales—usually a legitimate end justifies the means. See: *Colorado Interstate Gas Co.* v. *F.P.C., supra; Panhandle Eastern Pipe Line Co.* v. *F.P.C., supra; Wisconsin* v. *F.P.C.*, 373 U.S. 294. But, we know equally well that the method utilized must surely be within acknowledged jurisdictional limits which require an effective separation of regulated and nonregulated activities for the determination of the ingredients of the rate base. As applied to our case, it means a separation of profits and losses between regulated and nonregulated businesses in determining the tax allowance includible in the cost of service of the regulated company. "Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which Congress wrote into the Act." *Panhandle Eastern Pipe Line Co.* v. *F.P.C., supra,* p. 641.

And, as we have seen, the total tax liability is not affected when the Gas Company's tax liability at the 52 percent rate is included in the consolidated returns. Rather, the reduction in the total tax liability effected by the consolidated returns is due to the losses of the nonregulated companies. But, even so, under the Commission's method, the tax allowance of the Gas Company is made to depend upon the profits or losses, as the case may be, of the nonregulated companies.

It is thus plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the Act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside.

U.S. GOVERNMENT PRINTING OFFICE:1968

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *Petitioner,*

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, and TEXAS EASTERN TRANSMISSION CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioner, Memphis Light, Gas and Water Division ("Memphis Division"), respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered on February 10, 1966.

OPINIONS BELOW

The opinion of the Court of Appeals for the Fifth Circuit is not yet reported. It is printed as Appendix A to the Federal Power Commission's petition for a writ of certiorari to review the same judgment. The opinions and orders of the Federal Power Commission are reported in 31 FPC 1180, the relevant portions of which are pages 1190 and 1191, 32 FPC 687, 879, and 1163. The record has been filed in support of the FPC Petition for Certiorari.

JURISDICTION

The mandate of the Court of Appeals for the Fifth Circuit was issued on March 7, 1966 (FPC Pet. for Cert., App. B). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether, in fixing rates of a natural gas company, the Federal Power Commission must allow as part of the utility's cost of service the amount of federal income taxes it would have paid if it had filed a separate tax return, when in fact it filed a consolidated return with affiliated corporations, resulting in an overall tax saving for the group of affiliates.

STATUTE INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821-833, as amended, 15 U.S.C. 717-717w, and of the Internal Revenue Code of 1954, 68A Stat. 3, et seq., as amended, 26 U.S.C. 1-8023, are set out in the FPC Petition for Certiorari.

STATEMENT

Memphis Light, Gas and Water Division is a division and wholly-owned agency of the City of Memphis, Tennessee. Among others things, Memphis Division owns and operates a gas distribution system for the distribution and sale of natural gas throughout the City of Memphis and in Shelby County, Tennessee, to residential, commercial, and industrial consumers.

To meet the gas needs of these consumers, Memphis Division purchases natural gas from Texas Gas Transmission Corporation ("Texas Gas"), an interstate natural gas pipeline company, which, in turn, obtains substantial volumes of natural gas from United Gas Pipe Line Company ("United").

The most important and largest item affecting rates charged by Texas Gas to Memphis Division is the cost of gas purchased by Texas Gas from United and other sources. The cost of gas purchased by Memphis Division from Texas Gas is also the largest and most important element in the rates Memphis Division charges the ultimate consumers.

In the rate proceedings before the Federal Power Commission on United's proposals to increase its rates to Texas Gas and others, Memphis Division was permitted full intervention as a party and actively participated in the proceedings. In the court below, Memphis Division was also granted intervention; it filed a brief and participated in the oral argument in support of the Commission's orders.

Memphis Division adopts, without repetition, the "Statement" of the Federal Power Commission's petition for a writ of certiorari in which the proceedings before the Commission, United's operating and tax

filing practices, the Commission's findings as they relate to the question presented, and the decision of the court below are detailed.

REASONS FOR GRANTING THE WRIT

The importance of a definitive determination of the question presented is well-covered in the Federal Power Commission's petition for a writ of certiorari. Memphis Division adopts the reasons for granting the writ advanced by the Commission in its petition.

1. The decision of the court below will require the Commission to allow, and the consumers to pay, in rates an amount for federal income taxes in excess of the public utility's federal income tax liability, and thus, in effect, subsidize non-utility operations. For the Commission, under that decision, must ignore applicable cost allocation procedures and arbitrarily compute the public utility's income tax allowance on the fiction that the public utility files a separate tax return, although, in fact, it files no separate return but through participation in a consolidated tax return experiences a smaller tax liability due to recurring tax losses of an affiliated gas producer whose operations are an integral part of the public utility system.

The result of the decision of the court below will be to increase the cost of gas to over 100,000 gas consumers served by Memphis Division. The decision will also adversely affect the cost of gas to millions of gas consumers throughout the country who purchase gas sold by the 39 natural gas pipeline companies that participate in consolidated tax returns (FPC Petition for Certiorari, p. 15).

The effect of the Fifth Circuit's decision is not only far reaching in terms of the number of consumers that

will be adversely affected thereby, but it is also far reaching in the effect on "the primary aim" of the Natural Gas Act "to protect consumers against exploitation at the hands of the natural gas companies", *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U.S. 591, 610. The decision can only impede the Commission's administration of the Act to attain its objective.

2. Memphis Division readily agrees that consumers should pay every legitimate and reasonable cost actually incurred by the natural gas pipeline companies and their gas producing affiliates in rendering natural gas service, but Memphis Division submits that it is neither appropriate nor necessary nor lawful to require consumers to pay amounts which exceed the actual costs for federal income taxes or any other component of cost of service, and thereby allow the utility to earn excessive returns at the expense of the consumers.

A utility is not entitled to have included as an expense in cost of service an amount which will not be incurred. *Cities Service Gas Company* v. *Federal Power Commission* (CA 10, 1946) 155 F. 2d 694, 704, *certiorari* denied, 329 U.S. 773, rehearing denied, 329 U.S. 832. This rule is just as applicable where the cost incurred applies to more than one class of business, i.e., regulated or jurisdictional and non-regulated or non-jurisdictional, and is, therefore, a joint cost.

The application of the rule is merely more complex and more dependent on informed judgment and expertise where joint costs are involved, because an allocation is required to ascertain the utility's cost and to assign to each class of business only a fair share of the total joint cost actually incurred. Since United

participated in a consolidated tax return, allocation was required to determine United's tax cost that should be included in its cost of service and borne by the consumers.

Congress has prescribed no allocation formula which the Commission must use. *Colorado Interstate Gas Co.* v. *Federal Power Commission,* 324 U.S. 581, 589 (1945). The choice of the formula or method of allocation is for the Commission (*Ibid.*). The appropriateness of the formula raises questions of fact, not of law (*Colorado Interstate* case, *supra,* at page 590), and involves the exercise of informed judgment and discretion by those whose duty it is to make the "pragmatic adjustments . . . called for by particular circumstances." *Federal Power Commission* v. *Natural Gas Pipe Line Company;* 315 U.S. 575, 586. The courts are not warranted in rejecting the method selected by the Commission "unless it plainly contravenes the statutory scheme of regulation." *Colorado Interstate* case, *supra,* at page 589.

The Commission's regulatory responsibilities necessitate virtually constant use of joint cost allocation techniques in maintaining the jurisdictional limits fixed by Congress. For example, when oil and jurisdictional gas are produced jointly, more economically, as a rule, than if they were produced from separate wells, the Commission allocates the joint production cost rather than attributing to jointly produced gas the cost of gas produced as a single product. *Phillips Petroleum Co.,* 24 FPC 537, at pp. 553 et seq. (1960) affirmed *sub nom. Wisconsin* v. *FPC,* 303 F. 2d 830 (1961), affirmed 373 U.S. 294 (1963); *Area Rate Proceeding* (Permian Basin Area) 34 FPC —, Opinion No. 468, mimeo. ed., pp. 83-84 (1965). Such procedure results in the

savings of joint operations being shared between the gas consumers and non-jurisdictional oil business. *Cf.* Letter of Joseph C. Swidler, Chairman, FPC, to Hon. Harry Flood Byrd, Chairman, Committee on Finance, U. S. Senate reported in *Treatment of Tax Benefits Under Consolidated Returns, Hearings Before the Committee on Finance, United States Senate, Eighty-Ninth Congress, First Session, on Senate Amendment 426 to H.R. 7502* (1965), pp. 231-2.

The Commission chose a method of allocation in perfect accord with the actual historical tax practices of United and its affiliates, and the allocation methods prescribed by the Internal Revenue Code for tax purposes and the Securities and Exchange Commission for its regulatory purposes.[1] Under the allocation method selected by the Commission, the participants filing a consolidated tax return are first separated into regulated and non-regulated groups. The net taxable income of each group is next determined. Then, the net total consolidated tax liability for a representative test period is apportioned between the regulated and non-regulated groups, and among the companies in each group having income, on the basis of their respective incomes.

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[1] For tax purposes allocation of the consolidated tax liability is necessary to determine whether dividends paid are out of earnings or capital (26 U.S.C. § 1552). The SEC requires allocation to secure proper financial reporting to investors and the public. *SEC Holding Company Act Regulations,* Section 250.45(b)(6). Appendix A, *infra,* p. 1a. The provisions of the Internal Revenue Code and the Regulations of the SEC for allocation of the consolidated tax liability recognize the joint nature of the cost and require a sharing of the savings produced by the filing of a consolidated return. This procedure is in complete harmony with prevailing business practices.

By this method of allocation the Commission has assiduously respected the limits of its jurisdiction, while at the same time recognizing that the tax saving effected by the use of a consolidated return is for the benefit of all participants. Federal Tax Regulations, 1965, Vol. 1, Sec. 1.1502-31.[2]

The decision of the court below apparently proceeds on the theory that the tax savings effected through use of the consolidated tax return may not be attributed in any part to the regulated business where the tax losses offset against taxable income are associated with unregulated activities. In no other way can the decision of the court below that the "Commission's order was contrary to the requirements which Congress had imposed" be understood. (FPC Petition for Certiorari, Appendix A, p. 18).

Apart from the fact that the regularly recurring tax losses in this case were of a company which is United's "producing arm" (*Union Producing Company,* 31 FPC 41, 43 (1964); *Mississippi River Fuel Corp.* v. *Federal Power Commission,* 252 F. 2d 619, 622-3 (CADC, 1957); *Willmut Gas and Oil Co.* v. *Federal Power Commission,* 299 F. 2d 111 (CADC, 1962) and is subject to the Commission's jurisdiction, the theory disregards the fact that only through the income from the regulated utility operations, secured through rates

[2] In actual fact, the Commission's allocation method is biased in favor of the unregulated business for the tax losses of unregulated companies are first offset against the income of the unregulated group and only tax losses which are not thereby absorbed are offset against income of the regulated companies. Since the value of the recurring tax losses depends upon the existence of the taxable income of the regulated companies, the Commission would have been justified in selecting a method which apportions the total tax losses between regulated and unregulated companies.

paid by consumers, is there assurance that the producing department tax losses can be used to reduce taxes and can be utilized in full.

CONCLUSION

The writ should be granted. The effect of the decision of the court below is of major importance in the administration of the Natural Gas Act, and is in conflict with decisions of this court that leave to the Commission the selection of methods to allocate joint costs. The method selected by the Commission carefully respects the statutory scheme of regulation. The court below has substituted its judgment for the Commission's in a field peculiarly for the Commission's expertise.

Respectfully submitted,

REUBEN GOLDBERG
1250 Connecticut Avenue
Washington, D. C. 20036

GEORGE E. MORROW
Union Planters National
Bank Building
Memphis, Tennessee 38103

Attorneys for Petitioner

APPENDIX A

SEC Regulation Section 250.45(b)(6) Promulgated Under the Public Utility Holding Company Act of 1935

"(6) * * * *Provided:* That the consolidated tax liability of the companies joining in such consolidated tax return shall be allocated among the members of the group in accord with either of the methods of allocation prescribed by subparagraphs (a)(1) and (a)(2) of Section 1552 of the Internal Revenue Code of 1954; and *Further Provided:*

(i) That the tax allocated to each subsidiary company shall not exceed the amount of tax of such company based upon a separate return computed as if such company had always filed its tax returns on a separate return basis; and

(ii) That any excess of liability over a separate return tax which would be allocated to a subsidiary company but for subdivision (i) of this subparagraph shall be apportioned among the other members of the group, including the holding company (or other parent company), in direct proportion to the reduction in tax liability resulting to such members as measured by the difference between their tax liabilities computed on a separate return basis and their allocated portion of the consolidated tax liability."

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

Nos. 1301, 1302

FEDERAL POWER COMMISSION,

Petitioner

and

MEMPHIS LIGHT, GAS AND WATER DIVISION,

Petitioner

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPELINE COMPANY OF AMERICA, and TEXAS EASTERN TRANSMISSION CORPORATION,

Respondents

On Petitions for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

JOINT BRIEF OF RESPONDENTS, TEXAS EASTERN TRANSMISSION CORPORATION AND NATURAL GAS PIPELINE COMPANY OF AMERICA, IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI

Texas Eastern Transmission Corporation (Texas Eastern) and Natural Gas Pipeline Company of America (Natural) respectfully request that this Court deny the Petitions for Writ of Certiorari filed herein, by each petitioner, for the reasons set forth herein below.

QUESTION PRESENTED.

Were the United States Courts of Appeals for the Fifth and Tenth Circuits in error when they each held[1] that the Federal Power Commission cannot lawfully reduce the rates of a natural gas company subject to the Commission's jurisdiction, through a "consolidated effective tax rate" device, when such rate reduction would be effected by utilizing, for that purpose, the losses for tax purposes suffered by other corporate entities in the corporate system, the operations of which other companies are separate from those of the jurisdictional company, when such other corporations and/or their loss operations are not subject to Commission jurisdiction and when the filing of a consolidated tax return, which includes both jurisdictional and nonjurisdictional companies, does not produce a tax saving to the jurisdictional company nor to the corporate system as a whole. Were the courts below correct that the Commission erred in using the tax effect of such non-jurisdictional losses to reduce the jurisdictional company's rates, when the losses themselves were not borne by the jurisdictional company's costomers.

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[1] In *Cities Service Gas Co.* v. *FPC*, 337 F. 2d 97 (C.A. 10, 1964) and *United Gas Pipe Line Co., et al* v. *FPC*, 357 F. 2d 230 (C.A. 5, 1966).

STATEMENT OF THE CASE.

The decision hereinbelow by the Commission,[2] on the "consolidated tax issue" involved herein, was accomplished by perfunctory reference to the Commission's decision in *Cities Service Gas Co.*, 30 FPC 158 (1963). In both *United*, below, and in *Cities Service*, two of the five Commissioners strongly dissented. The Commission's *Cities Service* decision was reversed by the United States Court of Appeals for the Tenth Circuit, without dissent, opinion by Chief Judge Murrah.[3] The Commission's decision in *United* was reversed below by the United States Court of Appeals for the Fifth Circuit, without dissent, *per curiam*.[4]

United Gas Pipe Line Company (United), whose rates were in issue in the proceedings below before the Commission, is a natural gas pipeline system. United is regulated by the Commission as to about one-half of its operations.

United is a wholly-owned subsidiary of the United Gas Corporation (Corporation), which owns and operates natural gas distribution systems in various areas of Texas, Louisiana and Mississippi. Corporation is also the parent of Union Producing Company (Union), a company engaged in the exploration for and development and operation of both natural gas and oil production properties,

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[2] *United Gas Pipe Line Co.*, 31 FPC 1180 (1964).
[3] 337 F. 2d 97 (C.A. 10, 1964).
[4] 357 F. 2d 230 (C.A. 5, 1966).

and of United Overseas Production Corporation (Overseas), a corporation participating in an oil exploration project in Tunisia, North Africa. Corporation and Overseas are not subject to Commission jurisdiction. None of the oil operations, and only a portion of the gas operations, of Union are subject to Commission jurisdiction.

Together, these corporations (Corporate System) form an affiliated group that joins, for purposes of paying Federal corporate income tax, in a consolidated return filed by the parent, Corporation.

In its rate case before the Commission, involving its rates to its jurisdictional customers, out of which the proceeding below arose, United included as a component of its rates an amount reflecting reimbursement of federal income taxes computed at 52% of anticipated income. Fifty-two percent (52%) was, of course, the actual, lawful statutory tax rate in effect during the test year for the rate case.[5] The Commission, however, relying on its own decision in *Cities Service Gas Co., supra* (subsequently reversed, *Cities Service Gas Co.* v. *FPC*, 337 F. 2d 97 (C.A. 10, 1964)) rejected United's use of the normal public utility computation of a reasonable tax allowance, based on 52% of income. Instead, the Commission computed an allowance for federal income tax, for United's rates, on the basis of what *it decided* was a *proper* tax cost allowance. In essence, the Commission derived a "tax" rate less than the actual statutory rate, by use of a method

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[5] In 1964, the tax rate was reduced to 50% and to 48% for 1965 and thereafter. The rate was 52% in the years relevant to these proceedings, however (subject to surtax adjustment, which is ignored here for simplicity).

of computation which it referred to as reflecting an "effective consolidated tax rate," in arriving at its so-called "actual taxes payable." In fact, however, as will be shown below, United's own income was actually taxed at the statutory 52% rate, and the use of a consolidated tax return also did not result in a tax saving to the corporate system.

Basically, what the Commission did was to require a reduced tax component of United's rates by utilization of tax reductions and tax losses attributable to the unrelated and non-utility operations of affiliated companies, including companies and operations not subject to Commission jurisdiction. No part of the expenses which produced those losses, and no part of the losses themselves, have, of course, been used by the Commission in setting United's rates. Inclusion of such items would increase United's rates. Yet, the Commission has attempted to decrease United's rates by the tax effect of those losses on the system, in one year. The defects in this selective breach of corporate boundaries will be discussed below.

ARGUMENT.

The reasons why the decision of the Court of Appeals, below, need not be reviewed by this Court, will be summarized herein.

At the outset, it should be noted that although the petition herein speaks strongly of the dollar importance of these proceedings, the Solicitor and Commission did not think the matter of sufficient importance to seek review by this Court of the *Cities Service* decision in 1964, even though whatever consequences attach to the decision below were raised first, and in equal measure, in that case.

Further, there is no conflict among the United States Courts of Appeals regarding the question here involved, and neither Petitioner has been able to point out any conflict which this Court must resolve. The Petition on behalf of the Commission cites *El Paso Natural Gas Co.* v. *Federal Power Commission,* 281 F. 2d 567 (C.A. 5, 1960) and seems to indicate that the decision hereinbelow violates the "actual taxes" principle of *El Paso.* Yet, the decision below is by the same Court of Appeals for the Fifth Circuit which decided *El Paso,* and shows recognition of the fact that it is the Commission's decision hereinbelow which violates the "actual taxes" principle.

The short summary of this case is that the Federal Power Commission has violated its jurisdictional authority and has also ignored the actual source and nature of "consolidated tax return savings," all in its zeal to reduce pipeline rates, and has thus produced an illogical, as well as unlawful, result. That result has now been properly corrected by two United States Courts of Appeals.

1. THE COMMISSION'S VIOLATION OF ITS JURISDICTIONAL LIMITS.

The Commission's technique in achieving its "consolidated effective tax rate," as set forth, *inter alia*, in its Petition herein, shows that while the Commission purports to respect its own jurisdictional limits, it actually achieves its predetermined result only by utilizing tax losses of other companies in the Corporate System, which companies are not subject to Commission jurisdiction, to reduce the rates of United, which is subject to Commission jurisdiction. Footnote 8 at page 10 of the Commission's Petition herein makes this clear, when it admits that the Commission's method "may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group."

It is important to note, however, in addition to that damaging (to the Commission) admission, that the Commission's use of the terms "regulated" and "unregulated" is very specialized, and could be misleading. When the Commission's Petition herein states that the Commission's "consolidated effective tax" technique "separated the affiliated corporations into regulated and unregulated groups,"[6] the Commission uses "regulated" to mean regulated by *some* agency, but not necessarily regulated by the Federal Power Commission. Thus, even when dealing within the bounds of its own "regulated" category, the Commission exceeds the limits of its own jurisdiction. This is made clear at 31 FPC 1190-91, where the Commission stated that it had classified United Gas Corporation (the parent of Respondent United herein) as a regu-

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[6] Petition of Commission, p. 7.

lated company because it is partly regulated, in that it "engages in the distribution of gas and its rates are variously subject to regulation *by state commissions and municipalities.*" (emphasis added).

Thus, the method used by the Commission itself has, as its first step, a procedure which ignores the jurisdiction of the Commission itself and deals with an irrelevant category—the category of companies subject to jurisdiction by *someone*. The United States Courts of Appeals which have ruled on the "consolidated effective tax rate" technique have recognized this violation of the jurisdictional limits imposed upon the Commission by the Natural Gas Act,[7] and by the relevant decisions of this Court.[8]

In the earlier *Cities Service* case, the Tenth Circuit recognized this fact, stating:

> "We know, of course, that the Commission is free to choose most any method which it deems appropriate in the determination of just and reasonable rates for jurisdictional gas sales—usually, a legitimate end justifies the means. See: *Colorado Interstate Gas Co.* v. *FPC, supra; Panhandle Eastern Pipe Line Co.* v. *FPC, supra; Wisconsin* v. *FPC,* 373 U.S. 294. . . . But, we know equally well that the method utilized must surely be within acknowledged jurisdictional limits which require an effective separation of regu-

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[7] 15 U.S.C. § 717(b).

[8] For example, *Panhandle Eastern Pipe Line Co.* v. *Public Service Commission of Indiana,* 332 U.S. 507, 516 (1947); *FPC* v. *Panhandle Eastern Pipe Line Co.,* 337 U.S. 498, 503 (1949); *Panhandle Eastern Pipe Line Co.* v. *FPC,* 324 U.S. 635, 641-642 (1945); *Colorado Interstate Gas Co.* v. *FPC,* 324 U.S. 581 (1945).

lated and nonregulated activities for the determination of the ingredients of the rate base." (337 F. 2d at 100-101).

And that Court concluded (337 F. 2d at 101):

> "It is thus plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the Act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside."

This holding came after FPC Commissioners Woodward and O'Connor stated, in dissent in *Cities Service*, that:

> "[T]he majority view is unlawful because it has the effect of regulating non-utility enterprises beyond the Commission's jurisdiction; . . ." (30 FPC at 172)

Similarly, in the case below, Commissioners Woodward and O'Connor dissented to the "consolidated effective tax rate" method, and the United States Court of Appeals for the Fifth Circuit reversed, stating (357 F. 2d at 231):

> "• • • We do not think there are any such fact differences between Cities Service and this case as call for the application of any different rule of decision. The Court in the Tenth Circuit case held that the tax allocation as made by the Commission's order was contrary to the requirements which Congress had imposed. We think the Tenth Circuit case is correct and that the principles which are announced in its opinion are here applicable and controlling. The Commission's order, using an incorrect income tax rate in computing cost of service for the fixing of United's gas rates is erroneous and must be vacated and set aside."

In the proceedings below, except for its use of a "consolidated rate" income tax allowance, the Commission stayed within its jurisdictional authority and fixed United's jurisdictional rates solely on the basis of those costs, expenses, and revenues attributable to the jurisdictional business of United. In determining United's jurisdictional cost of service, the Commission quite properly did not include *any* of the costs and expenses of conducting the nonregulated businesses of United's affiliates. However, in devising the "consolidated tax method," the Commission has failed to comply with that jurisdictional requirement.

The Natural Gas Act limits the regulatory authority of the Commission to the transportation and/or sale for resale in interstate commerce of natural gas. The Act gives the Commission no regulatory authority over the local distribution of gas, nor does the Act give the Commission regulatory authority over any aspect of the oil business or over the affairs of a company engaged in overseas exploration for gas and oil. The Courts of Appeals have properly held that the consolidated effective tax rate method of apportionment of the total tax liability among the regulated companies, devised by the Commission in *Cities Service* and used by it in the proceedings below, fails to comply with those jurisdictional requirements.

2. THE "ALLOCATION" CLAIMS OF PETITIONERS.

The Petitions herein, for the Commission and Memphis Light, Gas and Water Division (Memphis), each speak at length about "allocations." The former claims that "the court of appeals did not criticize the particular allocation formula applied by the Commission (see Statement, *supra*, pp. 7-8); it apparently held that the Commission is power-

less to allocate under *any* formula—at least in a case like the present where some of the activities of the consolidated group that give rise to the tax losses are outside the regulatory regime of the Commission." (Petition of Commission, p. 10) And footnote 8, appended to the above passage, recognizes the defects of the Commission method. Memphis, on the other hand, goes on at length defending the particular allocation made by the Commission below.

What both Petitions fail to recognize, or disclose, is that there is a need for the Commission to *allocate* costs *only* when it is not possible to directly *assign* costs. That is to say, if it is clear that cost X is incurred directly by Company Y, or activity Y, it is not necessary, and is inaccurate and inequitable, to allocate a portion of a total cost into which cost X has been artificially placed, instead of assigning cost X, itself, to company Y. It is only a portion of a *joint* cost which must be allocated, because such cost is not separately incurred and, thus, is not directly assignable.

Federal income tax, on the other hand, is not a joint cost. It is incurred separately and directly by each company. A company's federal income tax liability for a given year is directly ascertainable from that company's income tax return. Since that is the case, there is no need to allocate costs—indeed, there is no joint cost to allocate.

Therefore, the Courts of Appeal have been quite correct in concluding that the consolidated tax "allocations" manufactured by the Commission have simply been a device to use tax losses of companies outside the Commission's jurisdiction to reduce the tax allowances of jurisdictional companies, to a level below the actual, separately computed taxes of such jurisdictional companies.

3. THE CLAIMS OF TAX "SAVINGS."

Underlying the Commission's decision in the proceedings below is the basic assumption, made by a bare three to two majority of the Commission in the *Cities Service* case and hereinbelow, that by filing a consolidated return, rather than separate returns, a group of corporate affiliates received an overall tax "saving." In fact, no such "saving" is received. The Commission, however, by holding that its decision in *Cities Service* was controlling below, apparently was convinced that the Corporate System in which United is a subsidiary had received such a "saving" for the test period. Proceeding on that assumption, the Commission apparently reasoned that United should share in this "saving" and that its share should be passed on to its jurisdictional customers in the form of reduced rates.

Both parts of this conclusion are faulty. In the first place, even if it were assumed, contrary to fact, that the use of a consolidated return did cause a tax saving for the Corporate System in which United is a subsidiary, it by no means follows that such saving, even if it existed, should be used to reduce the rates of *United*. The losses which would cause such saving are losses of subsidiaries of the parent company—Corporation. As such, such *losses* were not used to affect the rates of *United*, and properly so. As yet, the Commission would use the tax effect of such losses, and this despite the fact that the parent had more than enough income to "use up" the losses. Plainly, the stockholders of the parent company have financed, borne the costs and expenses, and suffered the losses of the nonregulated business of the loss company subsidiaries. Thus, those stockholders are entitled to the benefit of any tax savings which result from these non-

jurisdictional operations. As Commissioner Woodward said in his dissenting opinion in *Cities Service, supra*:

> "The parent company here owns, directly or indirectly, 100% of the stock of every corporation which participates in the filing of its consolidated return. As such stockholder it owns 100% of the assets of each corporation, and it is entitled to 100% of all net income of each, subject to income tax levies. Also, as the sole stockholder, it bears 100% of every risk, expense and loss sustained by its subsidiaries. These expenses and losses should not be appropriated for the consumers of a regulated natural gas company who bore no part of them, assumed no risks in relation to them, and have no right to use them to reduce their gas costs." 30 FPC at 173.

Thus, the allocation of the loss benefits (assuming allocation is needed and lawful, as it is not) is faulty, because United is not the responsible entity.

The Commission's Petition herein attempts to combat the above fact by claiming (at pp. 11 and 12 thereof) that the corporate group is an integrated, interdependent unit, each part of which is necessary to utilize the tax losses of the entities which are not subject to Commission jurisdiction. Such formulation has several vitiating defects.

a. As noted above, the profits of *United* are not necessary to utilize the losses of the non-jurisdictional loss companies in the system. The parent companies' profits are sufficient to offset such losses and make them useful.

b. As noted above, it is the parent company and its stockholders which take the risks of losses in the non-jurisdictional operations and subsidiaries, so that it is just (as well as jurisdictionally necessary) that they receive any tax offsets which such losses produce.

c. The assumption that a tax "saving" accrues to United itself, and to the Corporate System of which United is a part, by reason of the consolidated tax return filing, overlooks several facts. First, inclusion of United in the return increases the tax of the system by 52% of United's taxable income. Thus, its inclusion caused no "saving" or tax reduction. The Court of Appeals for the Tenth Circuit recognized this principle in *Cities Service*, and it is equally true here:

> "We think it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent Company. This approach cannot be justified by the actualities of the case. The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52% rate, but its tax liability at that rate was reported to the parent Company, and the consolidated returns actually reflect that tax liability." 337 F. 2d at 100.

It is also true that United's income was not necessary to "offset," and thus make use of, the losses of the non-jurisdictional companies and operations in the system, because of a factor in addition to the above described fact that the parent company's income is sufficient to offset those losses. That other factor is that the loss company itself could utilize the losses, in other years, by operation of the loss "carryover" and "carryback" provisions of Section 172 of the Internal Revenue Code of 1954, by which losses of one year can be "saved" and used to offset profits of the same company in other years. There is testimony in the record below that Union could generate profits to utilize past losses, if it had been necessary to do so. (R 2863, 3280) Again, "allocation" of such losses to United is unjustified and artificial.

CONCLUSION.

Joint Respondents respectfully submit that the only two United States Courts of Appeals which have considered the question herein, including the Court below, have correctly held that the Federal Power Commission's "consolidated effective tax rate" device utilizes illusory tax "savings" which result from the operations of separate companies which are not subject to Commission jurisdiction, to reduce the rates of United Gas Pipe Line Company, and that such action is in violation of the Commission's jurisdictional authority, violates proper standards for "allocation" and "assignment" of costs, and erroneously distributes cost burdens within the corporate system. The decision of the Court of Appeals below is correct. There is no conflict of Circuits to resolve. The Petitions for writ of certiorari herein should be denied.

Respectfully submitted,

JACK D. HEAD
JOSEPH F. WEILER
Texas Eastern Transmission Corporation
P. O. Box 2521
Houston, Texas 77001

KEITH M. PYBURN
Texas Eastern Transmission Corporation
Suite 852, Pennsylvania Building
Washington, D. C. 20004

Attorneys for Respondent, Texas Eastern Transmission Corporation

CLARENCE H. ROSS
CHARLES C. McDUGALD
WILLIAM W. BRACKETT
ROSS, HARDIES, O'KEEFE, BABCOCK, McDUGALD & PARSONS
122 South Michigan Avenue
Chicago, Illinois 60603

Attorneys for Respondent, Natural Gas Pipeline Company of America

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BRIEF OF RESPONDENT, UNITED GAS PIPE LINE COMPANY, IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI

Of Counsel:

W. O. CRAIN
General Counsel
P. O. Box 1407
Shreveport, La. 71102

K. W. KOLBE
C. D. FRENCH
2 Rector Street
New York, N.Y. 10006

LYNN R. COLEMAN
2024 First City National Bank Building
Houston, Texas 77002

THOMAS FLETCHER
2025 First City National Bank Building
Houston, Texas 77002

Attorney for Respondent United Gas Pipe Line Company

FIDELITY PRINTING COMPANY, INC., HOUSTON

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No. 1301
No: 1302

IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

FEDERAL POWER COMMISSION,
Petitioner,

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, AND TEXAS EASTERN TRANSMISSION CORPORATION,
Respondents.

MEMPHIS LIGHT, GAS AND WATER DIVISION,
Petitioner,

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, AND TEXAS EASTERN TRANSMISSION CORPORATION,
Respondents.

BRIEF OF RESPONDENT, UNITED GAS PIPE LINE COMPANY, IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI

COUNTER-QUESTION PRESENTED

Where a group of affiliated companies, which includes United,[1] files a consolidated Federal income tax return,

[1] In this brief references will sometimes be made as follows: United Gas Pipe Line Company, "United"; the Federal Power Commission, "FPC"; Staff of FPC, "Staff"; Memphis Light, Gas and Water Division, "Memphis"; Union Producing Company, an affiliate of United, "Union"; United Overseas Production Corporation, an affiliate of United, "Overseas"; United Gas Corporation, the parent of United, Union and Overseas, "Corporation"; and the Natural Gas Act will sometimes be referred to as the "Act". All emphasis will be that of the writer unless otherwise noted.

and where said return reflects tax losses of one or more of United's affiliates, which losses arise from, or include deductions from, non-utility operations which are not subject to the jurisdiction of the FPC and which are wholly unrelated and disassociated from the operations of United:

Should said losses or deductions from such unrelated, non-jurisdictional and non-utility operations be utilized by the FPC in computing the Federal income tax component to be included in United's cost of service on which United's regulated rates for the sale of gas are based?

COUNTER-STATEMENT OF THE FACTS

(a) **Proceedings Before FPC.** United, a natural gas company subject to FPC regulation, filed under § 4(d) of the Act, application for general increase of its jurisdictional rates. After full hearing, the FPC, on May 14, 1964, issued a rate order and Opinion No. 428 (R. 9107). Thereafter on rehearing, it issued two Opinions, No. 428-A on September 2, 1964 (R. 9704), and No. 428-B, on September 30, 1964 (R. 9859).

After petitions to review were filed in the Fifth Circuit, all issues before the FPC were settled except the Federal income tax allowance includible in United's cost of service — the only issue presented below for decision.

The FPC, in computing such Federal income tax allowance, applied a so-called "consolidated effective tax rate", lower than the applicable statutory corporate tax rate, which the FPC claims resulted from United joining its affiliates in filing a consolidated Federal income tax return. The FPC, declaring complete applicability and governance of its Opinion in *Cities Service Gas Co.*, 30 FPC 158, applied, to United, the *Cities Service* formula devised to synthesize the so-called "consolidated effective tax rate", and substituted it for the statutory rate.

United contends that it is entitled, the FPC obligated, to apply to its taxable income only the statutory rate in computing the allowance for Federal income taxes includible in its cost of service, unreduced by tax losses and deductions attributable to unrelated, non-jurisdictional, and non-utility operations of affiliated companies.

The FPC action gives United's jurisdictional gas customers the benefits of tax losses and deductions which are not United's but which arise mainly from unrelated, non-jurisdictional and non-utility *oil* operations of United's affiliate, Union, whose costs are not included in United's cost of service.[2]

(b) **The Judgment of the Court of Appeals.** In the Fifth Circuit, United asserted direct, unequivocal support for its contentions in the Tenth Circuit decision in *Cities Service Gas Co.* v. *FPC*, (1964) 337 F. 2d 97 (App. A, FPC Pet.), involving precisely the same issue before the Fifth Circuit.

The Tenth Circuit reversed and set aside the "method" devised by the FPC in *Cities Service*, which it applied to United. The Tenth Circuit held that "No 'tax savings' resulted from the inclusion of the Gas Company in the consolidated return" (App. 28); that "We think it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent Company" (App. 27); and after demonstrating that "the reduction in the total tax liability effected by the consolidated returns is due to the losses of the nonregulated companies", it concluded, "It is thus plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated

[2] The consolidated group included in 1961, Overseas, which is completely unregulated, and which had oil exploration operations in Africa (R. 516) producing a loss of $24,354.

profits and losses which Congress wrote into the Act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside." (App. 29, 30).

The Fifth Circuit studied this record and the Tenth Circuit decision, and concluded:

> "United would have us follow the Tenth Circuit's *Cities Service* decision. The Commission says that the *Cities Service* case is to be distinguished because of fact differences. It urges that the Tenth Circuit decision is wrong and should not be followed. We do not think there are any such fact differences between Cities Service and this case as call for the application of any different rule of decision. The Court in the Tenth Circuit case held that the tax allocation as made by the Commission's order was contrary to the requirements which Congress had imposed. We think the Tenth Circuit case is correct and that the principles which are announced in its Opinion are here applicable and controlling. The Commission's order, using an incorrect income tax rate in computing cost of service for the fixing of United's gas rates is erroneous and must be Vacated and set aside." (App. 20).

Thus, two Courts of Appeal were unanimous in holding the FPC orders unlawful in the jurisdictional aspects noted. This upheld the two Commissioners who dissented in the *Cities Service* and *United* proceedings. We find no court decision to the contrary.

ARGUMENT

THE FIFTH AND TENTH CIRCUITS' DECISIONS CORRECTLY CONSTRUE AND ENFORCE, WITHIN THE AMBIT OF THE ACT, APPLICABLE TAX PRINCIPLES

Only statutory tax rate applies in consolidated tax return situation. The decisions of the Fifth and Tenth Circuits

correctly reflect fundamental tax principles. They recognize that the pertinent tax statute prescribes only one tax rate — 52%. FPC and Memphis unsuccessfully sought to saddle United with a hypothetical, fictional "consolidated effective tax rate" — a complete stranger to the tax statute.

Both Circuits so recognized in requiring application of the statutory rate — the rate applied to United's taxable income — in determining the issue the FPC and Memphis pose here.

The Fifth Circuit, agreeing with the Tenth Circuit, correctly recognizes that if United filed a separate return, its tax allowance in cost of service would be computed at the statutory rate of 52%.

Implicit in the Fifth Circuit's decision is recognition that United, by joining in the filing of a consolidated return, retains its status as a separate entity as directed by governing tax Regulations.

Upon filing a consolidated return, a tax is paid on the group's aggregate taxable income. There is no merging or commingling of income and deductions of members in the affiliated group in the sense that separate corporate identity is lost. To the contrary, the tax Regulations — having the force of statute — preserve the separate corporate identity by specifically providing (Reg. Sec. 1.1502-30(a)) that tax liability shall be computed upon consolidated income, defined in the Regulations (Reg. Sec. 1.1502-31(b)), as a *combination* of taxable incomes, *computed separately*, of the members of the affiliated group. As these Regulations prescribe, so did the United group.

So, each company retains separate corporate identity; each company remains a separate corporate entity. Equal-

ly, both Circuits preserved the intent of the Regulations; both directed compliance with the statutory rate to compute tax allowance.

For the FPC to prevail, it would be necessary to calculate United's tax allowance, not on the basis of its own tax liability based on its own taxable income, but on the basis of the consolidated tax liability of the parent corporation. This is exactly what the FPC unsuccessfully attempted below and in the Tenth Circuit. The Tenth Circuit rejected, stating ". . . it is legally fallacious to calculate (Cities Service) Gas Company's tax allowance on the basis of the consolidated tax liability of the parent company." (App. 27).

Tax Liability of United Group Increased by 52% of United's Taxable Income. The Fifth and Tenth Circuit decisions correctly held that United and Cities Service incurred tax liability at the statutory 52% rate, and that the consolidated returns actually so reflected. It is perfectly clear that the tax liability of United's consolidated group was increased by exactly 52% of United's taxable income included in the consolidated return. The same situation existed in *Cities Service*.

The Tenth Circuit demonstrated that inclusion of Cities Service in the consolidated return increased consolidated tax liability by 52% of Cities Service income, so no "tax savings" followed from inclusion of Cities Service in the return. The Tenth Circuit employed a table (App. 28, fn. 4) clearly showing that inclusion of Cities Service in the consolidated returns increased consolidated tax lia-

bility by 52% of Cities Service's income. United employed the same type of table in the Fifth Circuit as follows:

Year	(1) Consolidated Tax — Including United[3]	(2) Consolidated Tax — Excluding United[4]	(3) United's Separate Tax at 52%[5]	(4) Sum of (2) Plus (3)
1957	$13,560,947	$ 240,742	$13,320,205	$13,560,947
1958	16,091,376	4,352,910	11,738,466	16,091,376
1959	11,356,973	470,069	10,886,904	11,356,973
1960	8,250,373	(885,735)	9,136,108	8,250,373
1961	7,940,211	(1,721,131)	9,661,342	7,940,211
Total	$57,199,880	$ 2,456,855	$54,743,025	$57,199,880

Such table conclusively demonstrates that inclusion of United in each return, for the five year representative period, increased consolidated tax liability of the affiliated group by 52% of United's income included in the consolidated return. It follows that no "tax savings" resulted from inclusion of United in the return. This was the precise result adjudged in *Cities Service*.

Below Memphis characterized United's table as a "shell game", saying such could as effectively be used for Corporation. But, United's table, like that of the Tenth Circuit, irrefutably shows that inclusion of United in the consolidated return had no effect on United save that which followed application of the statutory rate to United's taxable income. It necessarily follows, as both Circuits knew and declared, that the FPC's "device" to reduce the statutory tax rate and substitute therefor a

[3] After adjustment for capital gains. R. 9149.

[4] This amount is determined by subtracting United's taxable net income as it appears at R. 6524 (as adjusted for capital gains), from the consolidated taxable net income appearing at R. 6524 (as adjusted for capital gains), and multiplying the difference by 52%.

[5] This amount is determined by multiplying United's taxable net income (R. 6524), as adjusted for capital gains (R. 6215, 6219) by 52%.

"consolidated effective tax rate" hinged solely on Union's *unregulated oil losses* — tax losses beyond the jurisdictional reach of the FPC.

"Consolidated Effective Tax Rate" An FPC Device to Escape and Lower Tax Provided by Statute. The Fifth Circuit, declaring the Tenth Circuit's decision controlling, repudiates any theory that United's position is based on a theoretical or hypothetical tax.

This record indisputably shows that a tax resulting from application of the statutory rate to United's taxable income for the five year period utilized, was, in fact, paid. United's complaint was that the FPC instead of recognizing that clear fact, contrived a "consolidated effective tax rate" to derogate and reduce the tax allowance which United was lawfully entitled to have included in its cost of service — contrary to the rate Congressionally commanded. The Fifth Circuit rightfully redressed United's complaint.

Thus, the Fifth and Tenth Circuits fully recognize the fundamental axiom that income tax results from application of a *statutory* tax rate to taxable income. Hence, there is no such thing as a "consolidated effective tax rate." It is thus unmasked as a device, unlawfully to assign tax losses and deductions to companies having no right thereto. There is only one tax rate available for use to the FPC — and that rate is prescribed only by statute — the Internal Revenue Code.

Memphis' Claims Unfaithful to Fifth Circuit Decision. Memphis' claim, (p. 4), that the decision below "will require * * * consumers to pay, in rates an amount for Federal income tax in excess of the public utility's Federal income tax liability * * *" is nonsensical. Federal income tax results from application of the statutory rate to tax-

able income. United's "tax liability" cannot exceed income taxes so computed. Of course, by express provision of Regulation § 1.1502-15, United, joining in a consolidated return, is liable *in solido* for the consolidated tax.

Further, the Memphis notion (p. 4) that "*applicable cost* allocation procedures" must be ignored,[6] and that one joining "in a consolidated tax return *experiences* a similar tax liability * * *" begs the question. There are no "applicable allocation procedures", for taxes are not a joint cost requiring apportionment. Assuming them so does not make them so. United's tax liability issues only from its own separate taxable income. It "experiences" nothing but that liability.

The further assumption that these "experiences" result from "recurring tax losses of an affiliated *gas* producer" (p. 4) is even more unwarranted. This record shows that Union had an aggregate taxable income for the pertinent five year period *from gas* of $507,254 (Ex. 14-1, Sch. 2, R. 6210). The losses here arise from Union's non-jurisdictional, non-utility, unrelated *oil* operations.

Memphis (p. 6) misconceives *Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581. This Court there dealt with method of rate making, not method of allocation. The "pragmatic adjustments" pointed to rate methods. Allocation plays a rate-making part in separating jurisdictional from non-jurisdictional, as that case makes clear, so that rate methods within the frame work of the Act can be properly applied — or as in the Memphis illustration (p. 6), where oil and gas are produced from one well and the joint cost of production is allocated between jurisdictional and non-jurisdictional for the same purposes. It was the FPC refusal to allow separate incurrence of tax liability to remain separate, and

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[6] What is said here also applies to the FPC which advances the same claims (pp. 9, 10, 13).

its affirmative attempt to break out of the jurisdictional enclosure so as to mix non-jurisdictional with jurisdictional, to its own ends, that constituted the vice of illegality struck down by the Fifth and Tenth Circuits.

Conflict Between Memphis and FPC. To this point, (p. 7-8), Memphis has faithfully echoed each FPC claim, but here disarray appears. Memphis declares that the so-called three step "allocation" of the FPC *Cities Service* opinion "assiduously respected the limits of its jurisdiction." The FPC, however, is forced to confess (fn. 8, p. 10) that such "formula" does allocate, "the entire tax saving resulting from losses on unregulated activities to the regulated members" (*i.e.*, United).

The FPC suggests that this "problem", "need not be faced here" — but that "problem" it is, which produced the appeals by Cities Service in the Tenth Circuit and United in the Fifth Circuit, and the decisions of which FPC complains. The "problem" has been faced, and resolved, by the Fifth and Tenth Circuits. So, these petitions should be denied.

The responsibility of the FPC goes deeper than its Footnote 8 discloses, for United says that the application to it of the so-called "consolidated effective tax rate" was the result of design not connected with considerations of "tax savings" or "allocation" problems — and this is so, whether there are three steps or no steps. At the hearing level, United pressed the Staff witness on the baneful effect of the "consolidated effective tax rate" device, at which Staff Counsel Berkeley boldly interrupted to declare:

> "MR. BERKELEY: We will be glad to stipulate with you that the use of the consolidated tax *technique* will give to the benefit of United Gas Pipe Line customers, if you look at consolidated taxable income and actual consolidated tax, an effective tax rate lower than

52 percent, and that this results from taking into account Union's losses on oil as well as Union's losses on gas.

"MR. FLETCHER: Do I understand that the stipulation also includes that it was the *intended purpose* of the staff to take those benefits and give them to the customers of United Gas Pipe Line Company?

"MR. BERKELEY: *It was that purpose* to the extent that it reflects the actual effective tax rate paid by the three companies that participate in the tax return, yes." (R. 3468).

Wellhead to Burner-tip "System" — Misleading. The FPC statement (p. 5) that Union, United and Corporation "constitute an integrated gas utility system from wellhead to consumers premises" is not so. Below, we exposed this same statement as grossly misleading, for the truth is that less than one percent of Union's gas found its way to the burner tips of Corporation's customers.[7] Its repetition here is shocking.

Speculative Claims of Advantages from Affiliation — Without Substance. The FPC (p. 11) in effect says that Union and the consolidated group need and depend on United's profits to achieve a "tax savings" for the consoli-

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[7] Using the same 1964 Annual Report of Corporation which the FPC used (fn. 2, p. 5) and United's Form 2 for 1964 (p. 514, Col. (f)), an annual report which the FPC requires to be filed, United showed that the 80% of Union's gas sold to United constituted only 11% of United's gas supply. Form 2 shows that United in 1964 sold 1,438 billion cu. ft. Corporation's 1964 annual report shows that Corporation sold a total of 95 billion cu. ft. 96% (FPC 5) of 95 billion is 91.2 billion. This 91.2 billion cu. ft. sold by United to Corporation is 6.34% of the 1,438 billion total sales by United. Thus, 11% of the 6.34% or *less* than 1% of the gas purchased and sold by United represented gas which traveled from wellhead to burner tip through the Union-United-Corporation company group facilities. As we pointed out below, all of this information was available to the FPC before it wrote its brief below as well as this Petition.

dated group, and that thereby there is freedom "against entrepreneurial risks." The record refutes these pretensions. Memphis' Ex. 36 (revised) R. 6524, shows that the profits for the five years of the parent, Corporation, would alone be sufficient to offset Union's losses for such five year period. Nothing in the record supports the inference sought to be cast by the phrase, "against entrepreneurial risks". United's pipeline business is at no point manipulated to cover improper or improvident risks to be used to create what the FPC calls "tax savings."

This is of a class with the phrase (p. 12) "fully regulated members of the group". The FPC, of course, knows that no member of United's consolidated group is "fully regulated". The FPC confesses it regulates only 44% of United (fn. 1, p. 4). It knows it regulates only the interstate wholesales of gas of Union. It also knows that it has no regulatory supervision of Corporation, nor Overseas.

The FPC (p. 12) indulges in fanciful, unsupported conclusions about the advantages of affiliation. These ideas are wholly irrelevant to the issues here — viz, whether the FPC may transgress the jurisdictional bounds of the Act and take unrelated, non-jurisdictional, non-utility tax losses belonging to an affiliate and give them to the jurisdictional customers of another affiliated but partially regulated company. Neither the joys nor woes of "a vertically integrated enterprise", nor whether affiliation might furnish "an assured market"[8] shed any light on whether or not the Fifth

[8] The cavalier suggestion of "assured market" to Union (FPC p. 12) is as unfaithful to the record as the claim that the Fifth and Tenth Circuit decisions held the FPC without any power to adopt an allocation, is unfaithful to those decisions.

Rebuttal testimony of United's Vice-President C. C. Barnett (R. 86-122) is a complete exposition of the gas purchasing practices and policies of United. Nine factors (R. 87) control such purchases. We here lift up four: (1) United's contractual "take" obligations with various producers, (89% of these pur-

and Tenth Circuit decisions rightly called the turn on the FPC for its illegal attempt to override the limits of jurisdiction Congress marked out in the Act. Nor do such ideas change the fact that United's jurisdictional customers contributed nothing to the creation of Union's oil losses which the FPC is undertaking to kidnap.

Controlling Regulation, Qua Statutes, Require Preservation of Separate Entity. The FPC attempts to equate its claimed power to "allocate" consolidated tax liability among the members of a consolidated group with the Congressional intent underlying the consolidated return provisions of the Internal Revenue Code, citing (p. 13) *Erie Lighting*

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chases come from non-affiliated; 11% from Union, see *infra*, p. 11, fn 7); (2) State conservation and proration orders of local regulatory agencies in Texas, Louisiana and Mississippi, by which production allowables appear to each producer; (3) the "takes" of other purchasers within the same fields; and (4) United's obligation to all of its producers to govern its "takes" to prevent them being injured by drainage. Staff subjected Barnett to wide-ranging cross-examination (R. 2502-2640; 2725-41) liberally laced with inquiry into managerial judgment both from a business and operational standpoint. Memphis re-covered the field (R. 2640-99). Others also crossed (R. 2699-2701; 2701-6; 2706-24). The cross-examination so clearly and starkly confirmed the correctness and propriety of these practices, that Staff witness abandoned his exhibit pointed to a modification of some of those practices, and accepted in toto United's dispatching of estimated 1963 volumes (R. 4173, 4174).

The sum of all of the foregoing, undisputed as it was, conclusively showed that Union did not have and could not obtain an "assured market", but that it fell into its own contractual slot as did each other producer from whom United purchased.

We apologize to this Court that the record references in this footnote were not included in the Joint Appendix. We trust this Court will understand that the issue here is the validity and propriety of the contrived device labelled "consolidated effective tax rate", and not United's policies and practices with respect to purchased gas, including that purchased from Union, *all of which was fully covered by and included within the terms of the settlement of all issues save this "tax" issue.* The Commission order approving the settlement of all issues except the tax issue is at 32 FPC 1515, et seq.

Co. v. *Com.* (1937, 1 Cir.) 93 F. 2d 883, and two Congressional reports (one relating to the Revenue Act of 1928, the other, to that of 1934).[9] These citations contain references to those portions of the respective Revenue Acts dealing with consolidated returns. It is difficult to see how Congress, in 1928 and 1934, could have been concerned with the FPC's power to "allocate", for rate making purposes, the tax liability of a consolidated group, when the FPC and the Act under which it subjects United to its jurisdiction was not yet in existence.

The alleged Congressional sanction which the FPC seeks from the cited Congressional reports fails completely when it is recognized that such reports relate to Revenue Acts long ago expunged from the tax statute.

The separate company identity concept is expressly provided for in the current consolidated return Regulations, which have the force of law, promulgated under this Statute in effect during the pertinent period.

The authoritative work entitled "Consolidated Tax Returns" (Callaghan & Co., 1959) by Fred W. Peel, Jr., contains a passage which clearly refutes the single entity theory espoused by the FPC. Mr. Peel states (p. 1-2):

> "The consolidated return computations are not, however, based on a consolidated accounting of all income and capital items as though the properties of the subsidiaries were owned by the parent.[1] As the principles

[1] Unlike the rules provided in the present Regulations, consolidated returns originally involved a thorough going application of the principle of consolidation of accounts . . ."

[9] Under the 1928 Revenue Act, which is the subject of S. Rep. No. 960, the right to file consolidated returns was accorded to most affiliated groups of corporations. Under the Revenue Act of 1934 (H. Rep. No. 704), these rights were completely abolished and repealed except as they related to railroad corporations.

> governing consolidated returns have developed since 1917, this concept has been rejected. Instead, for most items there are separate computations for each corporate entity. The incomes so computed are then combined and adjusted by certain consolidated computations to arrive at consolidated taxable income."

This is precisely the procedure followed by the United consolidated group.

FPC Reliance on El Paso Misplaced. The FPC (p. 13-4), says that where a regulated pipeline company owns its own production the tax losses *"resulting from its gas operations"* are utilized in computing the tax allowance for that pipeline, and referring to *El Paso Nat. Gas Co.* v. *FPC*, (1960 5 Cir.) 281 F. 2d 561, cert. den. *sub nom California* v. *FPC*, 366 U.S. 912, asks what the difference is where such production is owned by a separate corporation. Apart from the fact that in the latter case there are separate owners instead of one owner, the short answer is that even on its own selected basis the FPC does not assert power to utilize *unregulated oil* tax losses, yet they are the losses here involved. Furthermore, *El Paso* stands for the principle that true "tax savings" of a regulated company obtained in respect of its regulated business, *i.e.* gas operations, are available to the regulatory agency. This principle would cover the first instance posed, where the regulated company had its own production. That it would not in the second is clear. The FPC sought to get under the tent of *El Paso* to justify its so-called "allocation" here — but the Fifth Circuit did not buy the attempt.

In any event, when the FPC specifies *"gas operations,"* as it does, it removes the point from this case which involves *oil operations.*

NO IMPORTANT FEDERAL QUESTION CALLING FOR SUPERVISION OF THIS COURT

Issues Judicially Reviewed. We find the approach in the two petitions here curious. The argumentative rationale of the FPC's *Cities Service* decision, 30 FPC 158, the Tenth Circuit rejected and vacated, holding that the FPC "devised a method" for computing tax allowance which transgressed the jurisdictional requirements which Congress wrote into the Act, because such method did not make an effective separation of regulated and non-regulated activities requisite to the determination of the ingredients of the rate base. Thus it breached this Court's warning that "Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which Congress wrote into the Act." *Panhandle Eastern Pipeline Co.* v. *FPC*, (1945) 324 U.S. 635, 641.[10]

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[10] This "off-limits" declaration was also proclaimed in *Colorado Interstate* v. *FPC*, (1945) 324 U.S. 581, cited by Memphis (p. 6) in which the Court declared:

> "Colorado Interstate and Canadian object to the Commission's use of the return. The Commission included in the total cost of service for these companies a 6½ per cent return on the rate base. In other words, the 6½ per cent return was computed on the basis of all the property used by petitioners in their various classes of business — intrastate sales, direct industrial sales, and interstate wholesale sales. Now it is apparent that if the reduction ordered was based on the excess of revenues from all classes of business over the aggregate costs, the result would be to reduce to a common level the profits from each class. In that case, whenever a company was making a higher return on its unregulated business than the rate of return allowed for the regulated business, the excess earnings from the unregulated part would be appropriated to the entire business. When the unregulated business was being operated at a loss or at less than the return which was allowed, excess earnings from the regulated business would be appropriated to the unregulated business. A low rate might therefore be concealed by siphoning earnings

Speaking of the Tenth Circuit decision, the FPC declared:

> "But that court decision which has now been issued is regarded by the Commission as clearly erroneous and one which the Commission must continue to regard as erroneous until the question is set at rest more authoritatively." (p. 21, FPC Response in 5th Circuit to United's Application for Stay.)

Instead of seeking correction of this "clearly erroneous" decision at the hands of this Court, it shopped a "conflict"[11] in the Fifth Circuit, asserting "fact differences" between this case and *Cities Service*. But the Fifth Circuit, after careful examination, found none as would require a different rule of decision.

No Basis for Claim of Hurtful Public Impact. But the instant petition abandons the "clearly erroneous", for it nowhere points to any legal error inherent in either decision; instead it advances a brand new approach, a strenuous effort to synthesize a public impact "horrendum" (p. 14-17). Memphis echoes (p. 4-5).

39 out of 77 pipelines (p. 15), says the FPC, file consolidated returns. Assuming this, arguendo, it presents no authority at the law for the FPC to transgress jurisdictional limits of the Act. Only Congress can stretch, or bend, or reset such limits. *El Paso*, as noted, recognizes FPC control over true tax savings had by a pipeline company from jurisdictional gas operations on production which that FPC regulated pipeline company owns. The Fifth and Tenth Circuit decisions hold the FPC may not go beyond

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from the unregulated business; a high rate might be built up by making the regulated business share the losses of the unregulated one." (p. 593-4). While the facts there did not require application of the rule, the rationale is the same as that of *Panhandle*, above.

[11] The FPC candidly conceded the search for a "conflict" in footnote 31, its brief in the Court below.

its jurisdictional restrictions to seize non-jurisdictional *oil* losses. These well considered decisions, in our estimation, are correct and in accord with Congressional intent.

The FPC caps this speculation with the artful ambiguity that "presumably the motive in each case was tax savings" (p. 15). "Tax savings" is the foggy phrase. For if "tax savings" has reference to the purpose and benefit envisioned by Congress in the consolidated return provisions, then, whether "tax savings" or not, is irrelevant. But if "tax savings" is meant to refer to the contentions made in the Fifth Circuit, and the Tenth Circuit, then both Courts categorically held that no "tax savings" resulted from inclusion in the consolidated return of the affiliate whose unrelated, non-jurisdictional and non-utility tax losses and deductions were, in the guise of "allocation", sought to be appropriated. Furthermore, if the "presumably" phrase is calculated to infer some improper motive, the petition shows no basis or facts to warrant the inference.

What is said of the 39 pipeline companies is equally applicable to "sixty-one" major electric utilities, recited, without more.

The last sentence of the first paragraph "Each such instance raises the question whether the consumer shall share * * " (p. 15) provokes two observations. First, the FPC is not talking about a "sharing" by stockholders and consumers — but a pure flow-through. Secondly, if such a broad issue can be raised by the neutral fact of 39 consolidated-return pipelines, that fact could in no fashion be persuasive upon the narrow jurdisdictional issue which the Fifth Circuit correctly determined.

The "many millions of dollars" (p. 16) are just as wanting in catalogued substance, as the cases cited in footnotes 12 and 13 are devoid of relevancy here. We have dealt

with these cases below and before the FPC. None of them involved use of a "consolidated effective tax rate" under circumstances similar to those involved here, *i.e.*, where non-utility, non-jurisdictional tax deductions are used as the FPC would do here.

Straining for some semblance of authority, the FPC cites two early FCC cases (p 15-6) as examples of parallel agency practice. No such support is forthcoming. *West Indies* (p 15) involved the question whether the incidence of World War II excess profits taxes could be transferred to the customer. The FCC's 1943 Report concluding that Congress intended the excess profits tax to be borne by the carrier involved no question of consolidated returns nor non-jurisdictional tax losses.

Next, the FPC resorts to a footnote in an exhibit attached to a long opinion by the FCC in *Western Union Telegraph Co.* (p 15-6). This opinion seems to show that someone, at some point, for some unexplained purpose, made an allowance based on a consolidated return, which computation was not of sufficient importance to receive attention in the FCC opinion, and which the FPC here does not show to have involved any character of non-jurisdictional losses, "allocated" as here.

Memphis attempts to proliferate the "horrendum" by escalating the number of consumers whose "cost" of gas is allegedly increased by the Congressional provisions both in tax statutes and the Act which the Fifth and Tenth Circuits declare and uphold (p. 4). But the directions of Congress in tax statutes is one thing, and the regulatory directions in the Act is another, nor can compliance and obedience to the tax statutes be claimed to produce an unlawful result under the Act.

United is well aware of this Court's statement in *FPC* v. *Hope Nat. Gas Co.*, (1944) 320 U.S. 591, 610, to which Mem-

phis adverts (p. 5). Even there, this Court (p. 603) noted the Act involved "a balancing of the investor and the consumer interests" for the protection of "a legitimate concern with the financial integrity of the company whose rates are being regulated."

Too, Memphis seems to forget that this Court admonished it and the FPC that this "legitimate concern" was a tangible purpose of Congress in the Act, for in *United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water,* (1958) 358 U.S. 103, this Court declared:

> "It seems plain that Congress, in so drafting the statute, was not only expressing its conviction that the public interest requires the protection of consumers from excessive prices for natural gas, but was also manifesting its concern for the legitimate interests of natural gas companies in whose financial stability the gas-consuming public has a vital stake. Business reality demands that natural gas companies should not be precluded by law from increasing the prices of their product whenever that is the economically necessary means of keeping the intake and outgo of their revenues in proper balance; otherwise procurement of the vast sums necessary for the maintenance and expansion of their systems through equity and debt financing would become most difficult, if not impossible." (p. 113).

Memphis terms Union the "producing arm" of United, citing *Mississippi River Fuel* v. *FPC,* (1957 CADC) 252 F. 2d 619 and *Willmut Gas and Oil Co.* v. *FPC,* (1962 CADC) 299 F. 2d 111. But it neglects to disclose that both cases involved a period before producers (and Union) were subject to FPC regulation. Thus, under the general rule obtaining where a regulated company acquired services from an unregulated affiliate, the regulating agency was empowered to check such relationship and price to insure

no improper advantages resulted. The legal rationale was that regulation afforded sanction against abuse, and its absence authorized scrutiny. The District of Columbia Circuit so distinguished the cited cases of *American-Louisiana Pipe Line Co.* v. *FPC,* (1965 CADC) 344 F. 2d 525, see fn. 12, p. 532.

But there are other cogent reasons which in our submission expose the "horrendum" as artificial and without merit. If this adjudication of invalidity of the FPC device — invalid because the FPC transgressed the jurisdictional bounds of the Act — had any such public impact as that which the FPC and Memphis seek to create, it seems more than strange that the FPC didn't flee to this Court following the Tenth Circuit decision and assert it.[12] For if there be such an impact, which United flatly denies, such impact was going on before *Cities Service.* But the FPC never advanced it initially or by Motion for Rehearing to the Tenth Circuit. Nor did the FPC or Memphis cry it out to the Fifth Circuit.

Furthermore, the tidal wave advanced by Memphis seems to have died aborning. When United filed this proceeding in the FPC, Exhibit 1-1 (R. 4874), et seq, showed United had 56 jurisdictional customers. Only 11 of the 56 intervened in the FPC.[13] 27 customers of customers intervened,[14] including Memphis. Yet this "horrendum" is advanced for

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[12] The FPC has said that *Cities Service* became moot because corporate rearrangement eliminated the right to make a consolidated return. This produces no mootness. Cities Service Ex. L FPC Dkt. CP65-162 shows that $4,545,000 depended upon the determination of this question, *i.e.,* if the FPC could do what it sought the judisdictional customers would be entitled to $4,545,000; if not, Cities Service would be entitled to this amount. This was far from moot.

[13] R. 7119; 7142; 7148; 7158; 7187; 7203; 7211; 7236; 7257; 7282; and 7302.

[14] R. 7131; 7137; 7165; 7171; 7179; 7194; 7217; 7229; 7242; 7248; 7263; 7270; 7293; 7327; 7334; and 7352.

the first time in these Petitions. Apparently two unanimous decisions from two Courts of Appeal which had effect to uphold the dissent of two Commissioners made a new approach imperative.

In any event, this area of the Petitions presents nothing, in our submission, calling for this Court's supervision.

CONCLUSION

United respectfully submits that these Petitions present no meritorious grounds for assumption of jurisdiction by this Court.

This record shows, indeed, in our submission, a careful assay of it, warrants the conclusion, that looking at the legal integrity of the Fifth and Tenth Circuit decisions, no doubt can exist that these Courts correctly construed the controlling principles enunciated by this Court, and that they have rightly declared the law.

Upon the coming in of the Tenth Circuit decision, the FPC characterized it as "clearly erroneous" and declared its refusal to obey pending more "authoritative" disposition. But the FPC failed, in truth it refused, to advise the Tenth Circuit wherein its decision was "clearly erroneous", thus depriving that Court of any opportunity to consider such complaints. Equally, it made no effort to seek from this Court which it had to know possessed adequate power,—any correction of "clear errors".

It followed the same course in the Court below. When, finally, it did seek entree to this Court, it does not assert "clear" or palpable error. Instead, it advances the astonishing claim that two decisions of two Circuit Courts of Appeal should be destroyed because conformity and obedience to law is not in the public interest. The claim of disastrous public impact, or, as we term it, the "horrendum" rings no clarion peal of credibility or merit.

The very timing of such claim in the light of the history of the Fifth and Tenth Circuit decisions, renders it suspect, for if the "horrendum" exists, which, in our opinion, the context of the Petitions denies, it does not result from the two decisions. The Petitions present the bold, bald claim that the jurisdictional limits of the Act prevents the FPC from confiscating unrelated, non-jurisdictional, non-utility tax losses and tax deductions belonging solely to a producer affiliate of a pipeline company under its jurisdiction, and thus prevents the FPC from donating these tax losses to jurisdictional customers of the regulated pipeline company as the proud fruit of unlicensed regulation. If the jurisdictional limitations are to be changed — only Congress has the authority.

Accordingly it is submitted that these Petitions for a Writ of Certiorari should be denied, and it is so respectfully prayed.

Respectfully submitted,

.....

THOMAS FLETCHER
2025 First City National
Bank Building
Houston, Texas 77002

Attorney for Respondent
United Gas Pipe Line
Company

Of Counsel:

W. O. CRAIN
General Counsel
P. O. Box 1407
Shreveport, La. 71102

K. W. KOLBE
C. D. FRENCH
2 Rector Street
New York, N.Y. 10006

LYNN R. COLEMAN
2024 First City National
Bank Building
Houston, Texas 77002

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 127

FEDERAL POWER COMMISSION, *Petitioner*

v.

UNITED GAS PIPE LINE CO., ET AL.

No. 128

MEMPHIS LIGHT, GAS AND WATER DIVISION, *Petitioner*

v.

UNITED GAS PIPE LINE CO., ET AL.

On Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR MEMPHIS LIGHT, GAS AND WATER DIVISION

REUBEN GOLDBERG
1250 Connecticut Avenue
Washington, D. C. 20036

GEORGE E. MORROW
Union Planters National Bank Building
Memphis, Tennessee 38103

Attorneys for Memphis Light, Gas and Water Division

September 1, 1966

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On Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF FOR MEMPHIS LIGHT, GAS AND WATER DIVISION

OPINIONS BELOW

The opinion of the Court of Appeals for the Fifth Circuit is reported at 357 F. 2d 230 (II R. 70-72). The opinions and orders of the Federal Power Commission are reported at 31 FPC 1180 (II R. 32-55), the relevant portions of which are pages 1190 and 1191 (II R. 40-42), and 32 FPC 687, 879, and 1163.

JURISDICTION

The judgment of the Court of Appeals was entered on February 10, 1966 and issued as its Mandate on March 7, 1966 (II R. 73-74). The petitions for writs of certiorari in Nos. 127 and 128 were filed on May 11, 1966. They were granted on June 13, 1966 (II R. 75-76). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether, in fixing the rates charged by a natural gas company, the Federal Power Commission must allow as a cost of service the amount of Federal income taxes the natural gas company would have paid if it had filed a separate tax return, when in fact it joined with affiliated corporations, whose operations are not entirely subject to the Commission's regulatory jurisdiction, in filing a consolidated tax return which resulted in a net tax saving for the participants.

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821-833, as amended, 15 U.S.C. 717-717w, and of the Internal Revenue Code of 1954, 68A Stat. 3, et seq., as amended, 26 U.S.C. 1-8023, are printed in an Appendix to the Brief for the Federal Power Commission in No. 127.

STATEMENT

1. The Interest of Petitioner, Memphis Light, Gas and Water Division

Petitioner Memphis Light, Gas and Water Division ("Memphis") is a division and wholly-owned agency of the City of Memphis, Tennessee. In addition to owning and operating water and electric distribution systems, Memphis owns and operates a gas distribution system for the distribution and sale of natural gas throughout the City of Memphis and in Shelby County, Tennessee, to residential, commercial, and industrial consumers.

To meet the natural gas needs of these consumers, Memphis purchases all of its natural gas requirements from Texas Gas Transmission Corporation ("Texas Gas"), an interstate natural gas pipeline company, which, in turn, obtains substantial volumes of natural gas from United Gas Pipe Line Company ("United").

The most important and largest item affecting Texas Gas' rates to Memphis is the cost of the gas purchased by Texas Gas from United and other suppliers. In turn, the cost of the gas purchased by Memphis from Texas Gas is also the largest and most important element affecting the level of rates Memphis must charge the ultimate consumers. Consequently, United's rates to Texas Gas are of vital concern to Memphis.

In rate proceedings before the Federal Power Commission ("Commission"), on United's proposals to increase its rates to Texas Gas and others, including the one giving rise to the present controversy, Memphis has been granted full intervention as a party and has actively participated in the proceedings. In the court below, Memphis was also granted intervention. It filed

a brief and participated in the oral argument in support of the Commission's orders.

The decision of the court below will require the Commission to allow, and the ultimate consumers of natural gas to pay, in rates an amount for federal income taxes in excess of United's share of the groups' federal income tax liability, and thus, in effect, require them to subsidize non-utility operations. For the Commission, under that decision, must compute United's income tax allowance on the fiction that it files a separate tax return, although, in fact, it files no separate return but through participation in a consolidated tax return experiences a smaller tax due to recurring tax losses of an affiliated gas producer whose operations are an integral part of the public utility system and which is subject to regulation by the Commission as a "natural gas company".

The decision of the court below, if affirmed, will increase the cost of gas to over 100,000 gas consumers served by Memphis. The decision will also adversely affect the cost of gas to millions of gas consumers throughout the country who purchase gas sold by the 39 natural gas pipeline companies that participate in consolidated tax returns (FPC Petition for Certiorari, p. 15).

The effect of the Fifth Circuit's decision is not only far-reaching in terms of the number of consumers that will be adversely affected thereby, but it is also far-reaching in the effect on "the primary aim" of the Natural Gas Act "to protect consumers against exploitation at the hands of natural gas companies", *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U.S. 591, 610. The decision can only

impede the Commission's administration of the Act to attain its objective.

Memphis readily agrees that consumers of natural gas should pay every legitimate and reasonable cost actually incurred by the natural gas pipeline companies and their gas producing affiliates in rendering natural gas service, including income taxes, but Memphis submits that it is neither appropriate, necessary, nor lawful to require consumers to pay amounts which exceed the actual costs for federal income taxes or any other component of cost of service, and thereby allow the utility to earn excessive returns at the expense of the consumers. *El Paso Natural Gas Company* v. *Federal Power Commission* (CA 5, 1960), 281 F. 2d 567, 571, *certiorari* denied, 366 U.S. 912. Tax savings will have been translated into additional profits for the benefit of United's parent.

2. Background of the Controversy

United is one of the largest interstate natural gas pipeline companies in the country. It sells natural gas for resale to other pipeline companies and distributors. As a "natural gas company" within the meaning of the Natural Gas Act, United's rates and charges for the interstate transportation and sale of natural gas for resale are regulated by the Commission (I R. 42).

United's parent is United Gas Corporation ("Corporation") and the affiliated companies are Union Producing Company ("Union") and United Overseas Production Corporation ("United Overseas").[1]

[1] United Overseas is engaged in foreign oil exploration (I R. 41). United Overseas participated in the consolidated tax return for the first time in 1961 when it had a net tax loss of $24,434 (I R. 41, 42, 87). Its role subsequent to 1961 is not revealed by the record (I R. 40, 41).

United, Union, and United Overseas are wholly-owned subsidiaries of Corporation (I R. 24, 37, 40).[2]

Corporation is engaged in the distribution of natural gas at retail in Texas, Louisiana, and Mississippi, and its rates therefor are subject to regulation by State or local regulatory authorities (I R. 40, 42). Corporation purchases practically all of the gas it distributes from United. *Standard & Poor's Corporation Records, Standard Corporation Descriptions,* July 30, 1965, Vol. 26, No. 21, Section 2, p. 3416.

Union is engaged in the exploration, development and operation of natural gas and oil properties (I R. 41). Union is United's "producing arm" or department, and about 80% of the gas produced by Union is sold to United. *Union Producing Company,* 31 FPC 41, 43-44 (1964); *Mississippi River Fuel Corporation* v. *Federal Power Commission,* 252 F. 2d 619, 622-623 (CADC, 1957); *Willmut Gas and Oil Company* v. *Federal Power Commission,* 299 F. 2d 111 (CADC, 1962). Union's rates for the sale of natural gas in interstate commerce, which includes its sales to United, are regulated by the Commission (I R. 42). *Union Producing Company, supra.* Its sales of oil and related gas liquid products are not regulated (I R. 42).

United dominates the system. Its gross operating revenues in 1961 were $298 million as compared to $50 million for Corporation and $52 million for Union. *Moody's Public Utilities Manual* (1962), p. 1368.[3]

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[2] Corporation owns all of the capital stock and all of the outstanding long-term indebtedness of each of the subsidiary companies (I R. 40).

[3] In 1965, United's gross operating revenues were $326 million; Corporation's were $57 million; and Union's were $53 million. *Moody's Public Utilities Manual* (1965) p. 1706.

During the period 1957 through 1961, of the system's taxable income, Corporation aggregated $9,024,170, or 7.89 per cent, and United aggregated $105,290,983, or 92.11 per cent (II R. 53).

By filing a consolidated Federal income tax return, as permitted by Section 1501 of the Internal Revenue Code (26 U.S.C. § 1501), the members of the System (Corporation and affiliates) realized tax savings which they could not have achieved by filing separate returns.[4] For the 1957 to 1961 period, the System's aggregate consolidated Federal income tax liability was $57,199,881 (II R. 53). Had United, Corporation and Union filed separate tax returns their combined tax liability for the same period would have been $59,291,919.[5]

The tax saving resulted from the fact that despite the substantial profits earned by Corporation, United and Union[6] during this period, special statutory tax deductions available to Union as an oil and gas producer (for depletion and intangible drilling costs) enabled Union for tax purposes to show a net tax loss,

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[4] A number of so-called name-saving companies are also included in the consolidated return (I R. 24, 40). These companies have no income or expenses and are, therefore, not germane to the question presented to this Court (I R. 40).

[5] The tax saving was actually substantially greater. This figure ignores about $5,000,000 of taxes Corporation, on a separate tax return basis, would have paid on dividends received from United and Union. Since these dividends do not enter into a consolidated tax return (the participants are treated as a single entity), the comparison has been made without regard to this additional tax saving.

[6] Union had substantial profits in the period 1957 to 1961. Its net income ranged from about $11,500,000 to about $18,000,000 (II R. 4).

for the period, of $3,869,626, which, under a consolidated tax return could be, and was, used to reduce the taxable net income of the System (I R. 38, 70; II R. 7-21).

The consolidated tax liability (and consequently the tax savings) is allocated by the System (I R. 34) in accordance with a method authorized by Section 1552 (a)(1) of the Internal Revenue Code (26 U.S.C. § 1552, § 1552(a)(1)) which provides that—

> "The tax liability shall be apportioned among the members of the group in accordance with the ratio which that portion of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income."[7]

Since Corporation and United were the only members of the group with taxable incomes, they shared in the consolidated tax liability (and the resultant tax saving) in proportion to their relative net taxable incomes (I R. 34). United, therefore, through its participation in a consolidated tax return incurs a tax which is substantially less than the tax it would incur on a separate tax return basis.

Cognizant of these facts, the Commission rejected United's claim for a Federal income tax allowance in cost of service based on the fiction that United files a

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[7] Allocation of the joint tax cost is required by the Code for tax purposes to determine whether dividends were paid out of earnings or capital. The Securities and Exchange Commission also requires allocation of the joint tax cost for the purpose of proper financial reporting to investors and the public, and authorizes use of the methods prescribed in Section 1552(a). *Regulations under the Public Utility Holding Company Act*, Section 250.45(b)(6).

separate tax return (II R. 41-42). It adhered (II R. 41) to its established administrative practice, at that time most recently reflected in its decision in *Cities Service Gas Company*, 30 FPC 158 (1963), where it stated that when a consolidated tax return is filed "the task is then to determine the proportion of the consolidated tax which is reasonably attributable to" the company before the Commission (30 FPC, at 162). The Commission there held that "the proper method to be applied in computing the Federal income taxes to be included in cost of service of a regulated company where that company has joined in a consolidated tax return with affiliates is" as follows (30 FPC at 164):

> "(1) separate the companies into regulated and unregulated groups,
>
> (2) determine the net aggregate taxable income of each group, and
>
> (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate making purposes, if computed on a separate return basis."

The Commission chose the 5-year period of 1957 to 1961, inclusive, as a representative test period upon which to determine United's Federal income tax allowance for cost of service purposes, and applied the allocation method adopted in the *Cities Service* case,

supra (II R. 41).[8] In the present case, since all of the participants were regulated and Union had no net taxable income against which to offset the net tax losses, it was only necessary to allocate the actual consolidated tax paid in the period of $57,199,881 between United and Corporation in proportion to their taxable incomes for the 5-year period of $105,290,983 and $9,024,170, respectively (II R. 53).[9] The average annual consolidated tax for the 5-year period was $11,439,976. Since United's taxable income was 92.11 per cent of their total taxable income, United's share of the average annual consolidated tax for the 5-year period was $10,537,362. This was an effective tax rate of 50.04 per cent when related to United's separately computed average annual taxable income for the 5-year period of $21,058,197 (II R. 53).[10]

Using this average effective tax rate of 50.04 per cent,[11] and the test year taxable income of $19,868,464, the Commission included $9,942,179 in United's cost of service for Federal income taxes (II R. 52) instead

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[8] The Commission used a 5-year period for test period purposes to determine the appropriate tax allowance since a single year might not be representative of the company's experience.

[9] Although United Overseas is unregulated, it was disregarded because the record showed its participation only in 1961 with a tax loss of $24,354 which averaged about $5,000 for the 5-year test period and represented only .00023 percent of the average taxable income. In the circumstance, United Overseas could have no significant effect on the apportionment.

[10] Under the allocation method followed by the System, the tax actually allocated to United during the period represented an effective tax rate of 48.8 per cent (Ex. No. 36 (Rev.), T. 6524).

[11] The use of an effective tax rate to reflect tax savings realized through filing a consolidated tax return has been common practice in Commission cases for many years. *infra*, pp. 15-16.

of $10,331,601 (computed at 52 per cent) on the basis of a separate tax return.

On review, the court below simply adopted as its own the reasoning of the Tenth Circuit in *Cities Service Gas Company* v. *Federal Power Commission*, 337 F. 2d 97, in which the Tenth Circuit set aside the Commission's order in the *Cities Service* case, *supra*, 30 FPC 158. On the authority of the Tenth Circuit's decision, the court below held that United's Federal income tax allowance should have been computed on a separate return basis at the 52 per cent tax rate (II R. 71-72; 357 F. 2d 230, 231).

The Tenth Circuit in *Cities Service* stated (337 F. 2d at 98) that "reduction in the total tax liability resulted from offsetting the losses incurred by certain *non-regulated* affiliates against the taxable income of all other affiliates", and that, therefore—

> "The decisive question is whether the Commission, in the exercise of its undoubted power to determine just and reasonable rates for jurisdictional gas sales, may, in these circumstances, take into account the losses of *nonregulated* and *unrelated* affiliates to calculate the tax allowance includible in the cost of service of a regulated company." (Italics supplied)

The Tenth Circuit held that the Commission had assigned the losses of the *unregulated* and *unrelated* business to the regulated business in violation of the Congressional requirement of a separation of the profits and losses between regulated and non-regulated business (337 F. 2d, at 101). In this case, the tax losses were incurred by a *regulated* and *related* affiliate,[12] but the court below did "not think there

[12] See page 6, *supra*.

are any such fact differences between *Cities Service* and this case as call for the application of any different rule of decision." (II R. 72; 357 F. 2d, at 231).

SUMMARY OF ARGUMENT

I

Assuming, *arguendo*, as the court below held, that only tax losses of regulated and related companies, participating in the filing of a consolidated tax return, may be considered in determining United's share of the consolidated income tax liability of the group, the Commission properly took into account Union's tax losses.

Union is a regulated and related company. Union, like United, is a wholly-owned subsidiary of Corporation. Union is also the production department of United, and as a 100 per cent affiliate "stands in the same position as does the integrated producing 'arm' of a pipe-line company". *Mississippi River Fuel Corporation* v. *Federal Power Commission*, 252 F. 2d 619, 622 (CADC, 1957).

Union sales of natural gas in interstate commerce —80 per cent to United—are regulated by the Commission. *Union Producing Company*, 31 FPC 41 (1964). Its oil operations are unregulated, but almost all of its oil production comes from wells which also produce natural gas.

Additionally, Union's cost of service, on which its rates to United are based, includes an allocated portion of Union's exploration and development costs. The allocation is made on the basis of Union's total exploration effort without regard to the hydrocarbon that may be discovered. These costs are borne by the consumers.

Finally, even if there are unrelated and unregulated activities of Union, no separation of Union's tax deductions between unrelated and unregulated and regulated and related operations was necessary. All that was required was a fair allocation of the consolidated income tax among the participants of the group. *Colorado Interstate Gas Company* v. *Federal Power Commission,* 324 U.S. 581, 588, 590-591 (1945).

II

In addition to Union's status as the production arm of United and a regulated natural gas company, other factors sustain the consumers' participation in the tax savings flowing from the consolidated tax return.

Union's and United's capital requirements are provided by Corporation, their parent, through the issuance of Corporation's securities to the public. United's cost of capital is, therefore, the cost of attracting capital to the System. The higher degree of risk of Union's production operations results in a higher System cost of capital which is reflected in United's rate of return and is borne by the consumers. Since the consumers bear a higher cost of capital attributable to Union's greater risks, the consumers are entitled to share in the tax savings realized by the System through offset of Union's tax losses against the taxable income of United and Corporation.

Additionally, through United's taxable income, assured by the consumers, the tax losses of Union are translated into assured tax benefits at 100 cents on the dollar. Without the assured taxable income of United, the tax losses are of only speculative value. Whether Union, in the carry forward and carry back period

prescribed by the Internal Revenue Code, would have taxable income to turn the tax losses into tax benefits, in whole or in part, is speculative.

III

The court below erred in holding that United, despite its participation in a consolidated tax return, actually incurred a federal income tax liability equal to 52 per cent of its taxable income and was, therefore, entitled to such an allowance in cost of service for federal income taxes.

While each company participating in a consolidated tax return, which has taxable income, viewed separately, *contributes* 52 per cent of that income to the tax liability of the System, there is no *separate computation or assessment of tax* and no *separate tax liability* for each participant in a consolidated tax return.

There is a single tax liability computed by (1) adding up the taxable incomes of each company, (2) reducing this sum by the tax losses of other companies in the group, and (3) multiplying the net taxable income of the group by the statutory tax rate. Had the court below computed a tax liability on a separate return basis for each participant, instead of for United alone, the court would have found that the summation of the separate tax liabilities would have exceeded the consolidated tax liability of the group, thus demonstrating that United, contrary to the court's holding, did not incur a tax liability equal to 52 per cent of its taxable income.

IV

The Commission allocated the consolidated tax liability between United and Corporation, the only

participants of the group with taxable income, on the basis of their respective average taxable incomes in the test period. This was eminently fair since tax liability is a function of taxable income and the rate, and Union had no taxable income. The Commission was not required to segregate properties or corporations. *Colorado Interstate Gas Company* v. *Federal Power Commission, supra.*

ARGUMENT

The Commission adhered to its long-established, administrative practice of including in cost of service an allowance only for taxes actually incurred. Where the company has participated in a consolidated tax return, the Commission has consistently refused to include a hypothetical tax allowance in cost of service based on a separate tax return. The Commission has included in cost of service only a tax allowance at the effective tax rate resulting from participation in the consolidated tax return. *Penn-York Natural Gas Company,* 5 FPC 33, 39 (1946); *Hope Natural Gas Company,* 10 FPC 583, 612, affirmed, 10 FPC 625 (1951); *Atlantic Seaboard Corporation,* 11 FPC 486, 515, affirmed, 11 FPC 43 (1952); *United Fuel Gas Company,* 12 FPC 251 (1953); *Hope Natural Gas Company,* 12 FPC 342, 347 (1953); *Home Gas Company,* 13 FPC 241 (1954); *Michigan Wisconsin Pipe Line Co.,* 13 FPC 326, 356, 373 (1954); *United Fuel Gas Company,* 23 FPC 127, 134 (1960). In *United Fuel Gas Company, supra,* 12 FPC at 265, the Commission said:

> "We have consistently held that consumers should be charged for only the actual liability for Federal income taxes. . . . If, by filing a con-

solidated return, a reduction of this cost is effected, such reduction should be reflected in the cost charged to consumers."

To arrive at United's fair share of the tax saving—and thereby to determine United's tax allowance for rate regulatory purposes—the Commission apportioned the consolidated tax liability among the participants in the consolidated return on the basis of their respective taxable incomes. United and Corporation had taxable incomes; Union had a net tax loss. Therefore, the consolidated tax was apportioned only between United and Corporation. On the basis of their respective taxable incomes, 92.11 per cent of the consolidated tax liability was allocated to United and 7.89 per cent to Corporation. The effective tax rate was 50.04 per cent.[18] The Commission applied this effective tax rate to compute United's tax allowance for cost of service purposes.

The court below reversed the Commission, adopting as its own the reasoning of the Tenth Circuit in the

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[18] The Commission has the duty, responsibility and right to determine what elements should be included in cost of service and the reasonable amount to be included for each element. The System's allocation method is not binding on the Commission in an affiliated situation. *Mississippi River Fuel Corporation* v. *Federal Power Commission*, 252 F. 2d 619, 622 (CADC, 1957); *Cities Service Gas Company* v. *Federal Power Commission*, 155 F. 2d 694 (CA 10, 1946), *certiorari* denied, 329 U.S. 773 (1946). Among the financial abuses uncovered by the Federal Trade Commission investigation which Congress intended to eliminate by enactment, in 1935, of the Public Utility Act of 1935 and Parts II and III of the Federal Power Act were the parent company's practices of assessing against the operating subsidiary a tax liability which deprived it of any benefit of the tax saving resulting from participation in the consolidated tax return. The tax saving thereby became additional profit to the parent. Senate Doc. 92, Part 72A, 70th Congress, 1st Session, pp. 477-482.

Cities Service case, *supra*. In *Cities Service*, the Tenth Circuit stated that the tax savings resulted from tax losses of "unregulated corporations whose business activities are entirely unconnected with and dissimilar to those of the regulated natural gas company transporting and selling such gas" and held that the Commission could not legally consider tax losses of "non-regulated and unrelated affiliates to calculate the tax allowance includible in the cost of service of a regulated company" (337 F. 2d at pp. 98, 99). Additionally, the Tenth Circuit held that the natural gas company in that case had, in fact, experienced a 52 per cent tax liability notwithstanding its participation in the consolidated return (337 F. 2d at pp. 100-101). On the facts of this case, and as matter of principle, the court below erred.

I.

ASSUMING, ARGUENDO, ONLY TAX LOSSES OF REGULATED AND RELATED COMPANIES MAY BE CONSIDERED BY THE COMMISSION, UNION'S TAX LOSSES WERE PROPERLY CONSIDERED BY THE COMMISSION IN DETERMINING UNITED'S FEDERAL INCOME TAX ALLOWANCE.

Union is engaged in the exploration, development and operation of natural gas and oil properties, and has been judicially declared to be United's "producing arm" or production department. Eighty per cent of the gas produced by Union is sold to United. Union's sales of natural gas to United and rates therefor, as are all of Union's sales in interstate commerce, are regulated by the Commission under the Natural Gas Act. I. R. 41, 42; *Union Producing Company*, 31 FPC 41, 43-44 (1964); *Mississippi River Fuel Corporation* v. *Federal Power Commission*, 252 F. 2d 619, 622-623 (CADC, 1957); *Willmut Gas and Oil Company* v.

Federal Power Commission, 299 F. 2d 111 (CADC, 1962).

Union's oil operations are unregulated, but almost all of Union's oil production comes from wells which also produce natural gas. Only 9.6 per cent of its net investment is applicable to 100 per cent oil fields. *Union Producing Company*, 31 FPC 41, 79 (1964). Union's cost of service, on which its rates to United are based, includes an allocated portion of Union's exploration and development costs which is made on the basis of Union's total explorations effort without regard to the hydrocarbon that may be discovered. Consequently, a *pro rata* share of the burden of Union's total exploration activities, whether related to regulated gas activities or unregulated, albeit related, oil activities, is underwritten and borne by the consumers.

On the basis of these facts, Union's tax losses were certainly those of a regulated and related affiliate and, by the test enumerated by the Tenth Circuit, and adopted by the court below, were properly taken into account by the Commission. No separation of Union's tax deductions between regulated and unregulated business, or between related and unrelated activities, was necessary, any more than a separation was necessary of the regulated and unregulated business of United, assuming part of the tax deductions were in fact the result only of unregulated oil operations, and assuming further that oil operations that are largely and intimately associated with the production of gas can be said to be unrelated to the regulated gas operations. A fair allocation of the consolidated income tax among the participants is all that is required. *Colorado*

Interstate Gas Company v. *Federal Power Commission*, 324 U.S. 581, 588, 590-591 (1945).[14]

Indeed, if Union's operations were part of the United corporate entity, rather than in a separate corporate entity, no one for one moment would think of suggesting that the tax deductions associated with the production operations must be disregarded in computing United's federal income tax allowance. *El Paso Natural Gas Company* v. *Federal Power Commission*, 281 F. 2d 567, 573 (CA 5, 1960), *certiorari* denied, 366 U.S. 912. In that case, El Paso Natural Gas Company was engaged in the production, transportation and sale of natural gas. It contended that its federal income tax allowance for rate purposes should be computed without regard to the savings in taxes produced by the tax deductions for statutory depletion and

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[14] See also *Panhandle Eastern Pipe Line Company* v. *Federal Power Commission*, 324 U.S. 635, 642, 646, 647, where this Court approved a profit-sharing formula in lieu of an allocation. And compare the cases where the courts have approved the Commission's use of revenues from extraction operations, which served to make the gas more marketable but reduced its heating value, to reduce the pipeline company's cost of service, without requiring the Commission to make an allocation between extraction operations related and unrelated to the marketing of the gas. *Panhandle Eastern Pipe Line Company* v. *Federal Power Commission*, 305 F. 2d 763 (CADC, 1962, *certiorari* denied, 372 U.S. 916); *Panhandle Eastern Pipe Line Company* v. *Federal Power Commission*, 348 F. 2d 340 (CADC, 1965), affirming 32 FPC 636 (1964); *Hope Natural Gas Company* v. *Federal Power Commission*, 134 F. 2d 287, 307-308 (CA 4, 1943), reversed on other grounds, 320 U.S. 591 (1944); *Cities Service Gas Company* v. *Federal Power Commission*, 155 F. 2d 694, 703 (CA 10, 1946), *certiorari* denied, 329 U.S. 773 (1946). In the present case the Commission has made an allocation.

intangible well-drilling costs. The Fifth Circuit disagreed, saying (at page 573):

> "We think, in short, there is no statutory authority for the Commission to treat actual savings in taxes to which natural gas companies are entitled any differently than savings in any other cost of service. It is the obligation of all regulated public utilities to operate with all reasonable economies. This applies to tax savings as well as economies of management. The net result of this, of course, is that such savings as are effected are passed on to the consuming public. This we consider to be the natural and necessary consequence of rate regulation.
>
> * * * * *
>
> "We conclude that the two true tax savings are to be treated alike. Other than the depreciation item, whatever federal income taxes were actually paid for the test year should be treated as part of the cost of service regardless of whether these taxes were less than would have been paid but for the depletion allowance and the deduction for intangible drilling expense. No theoretical amount not actually paid can be so included."

The court's reasoning is no less applicable to the present case. "A 100 per cent affiliate stands in the same position as does the integrated producing 'arm' of a pipe-line company", *Mississippi River Fuel Corporation* v. *Federal Power Commission*, 252 F. 2d 619, 622 (CADC, 1957). The D.C. Court of Appeals in stating this general rule was there applying it specifically to Union.

Consequently, by the tests established by the court below, it erred in holding that the Commission's order transgressed its statutory authority.

II.

OTHER CONSIDERATIONS DISCLOSE PROPRIETY OF OFFSETTING UNITED'S TAXABLE INCOME WITH A FAIR SHARE OF UNION'S TAX LOSSES FOR RATE MAKING PURPOSES.

Regardless of Union's status as the production arm of United and as a regulated natural gas producer, there are factors present which sustain the consumers' participation in the tax savings. United and Union have no securities outstanding in the hands of the public. All of their securities are held by their parent, Corporation. The capital requirements of United and Union are supplied by Corporation through the issuance of Corporation's securities which are widely held by the investing public in the United States. United's cost of capital, which determines its fair rate of return, is, therefore, the cost of attracting capital to the System, and the Commission has provided rates of return for United and Union on this basis. *United Gas Pipe Line Company,* 25 FPC 35, 108-109, 110, 115, affirmed 25 FPC 26, 32 (1961); *Union Producing Company,* 31 FPC 41.

Exploration, development, and production operations of Union involve higher degrees of risk and uncertainty than do the pipeline operations of United. This higher degree of risk is reflected in the cost of capital incurred by Corporation in raising capital and is, in turn, reflected in the rate of return awarded United in light of that cost of capital. Thus, United's consumers bear increased costs of capital directly traceable to Union's riskier operations. Since United's consumers bear a higher cost of capital due to Union's greater risks, it is appropriate, and fairness and equity require, that the consumers share in the tax savings realized by the System by reason of the offset

of Union's tax losses against the taxable income of United and Corporation.[15]

Additionally, United's consumers are entitled to a fair share of the tax savings available to the System through offset of Union's tax losses against United's and Corporation's taxable income because there is no assured realization of the *full* benefit of the tax losses without the taxable income of United provided by the consumers. In fact, without the assured profits of United, there is no assurance that *any* tax benefit could be realized from Union's tax losses.

Unless used in a consolidated tax return as an offset to taxable income, Union's tax losses could only be used by Union as an offset to taxable income of its own in filing a separate tax return. If Union filed a separate tax return, it would have the right to offset its tax losses against taxable income of three prior years or against the taxable income of five prospective years (26 U.S.C. § 172). There must be taxable income to make this right valuable, and the taxable income must be of sufficient level to absorb the tax losses if the tax losses are to have a value equal to 100 cents on the dollar. It is entirely speculative whether Union would have taxable income within the prescribed time periods to enable it to turn tax losses into tax benefits and the extent to which this might be possible. On the basis of past experience during 1957 to 1961, as shown by the record (Ex. No. 36 (Rev.); T. 6524),[16] Union had

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[15] Pipeline companies have branched into unregulated, and sometimes unrelated, ventures with the knowledge that the tax losses of these ventures can be turned into tax benefits by reason of the ever-present, assured taxable income of the regulated business.

[16] "T." followed by page references refers to the portion of the record which has not been printed. The page reference is to the numbering employed by the Commission in certifying the record to the court below.

taxable income only in 1958 and in an amount insufficient to absorb more than 50 per cent of the tax losses for the 5-year period.

By filing a consolidated tax return, however, because of the assured taxable profits provided by United's consumers, the tax losses are translated into assured tax benefits at 100 cents on the dollar.

This contribution which the consumers make is of no small moment, and of itself is sufficient to sustain the consumers' participation in the tax saving resulting from the consolidated tax return.

III.

UNITED INCURRED NO TAX LIABILITY EQUAL TO 52 PER CENT OF ITS TAXABLE INCOME.

A basic premise of the Tenth Circuit, which the Fifth Circuit adopted, was that Cities Service Gas Company actually incurred a tax liability of 52 per cent of its separate taxable income, notwithstanding its participation in the consolidated tax return (337 F. 2d 100). Therefore, it reasoned that the Commission should have included in cost of service a federal income tax allowance based on 52 per cent of Cities Service Gas Company's taxable income.

The Tenth Circuit arrived at its conclusion by a mathematical exercise (337 F. 2d, at p. 100, note 4). The Tenth Circuit computed the regulated company's separate tax liability at 52 per cent of its taxable income. This amount was subtracted by the court from the consolidated tax liability, and the resulting balance was described as the "Consolidated tax (excluding Gas Company)." The Tenth Circuit then added back the separate tax liability which produced the original consolidated tax liability including the

Cities Service Gas Company.[17] From this the Tenth Circuit concluded (337 F. 2d 100, 101):

> ". . . The simple fact is that the tax liability of the Gas Company as reflected in the consolidated returns was not hypothetical, but an actual cost to the Gas Company."
>
> * * * * *
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> ". . . as we have seen, the total tax liability is not affected when the Gas Company's tax liability at the 52 per cent rate is included in the consolidated returns. Rather, the reduction in the total tax liability effected by the consolidated returns is due to the losses of the nonregulated companies."

A similar mathematical exercise was performed by United in the court below to show that United, notwithstanding its participation in a consolidated tax return which produces a tax saving, incurred a tax liability equivalent to 52 per cent of its separate taxable income. The Fifth Circuit apparently agreed.

The mathematical exercise is utterly meaningless as is the conclusion drawn therefrom that Cities Service Gas Company, and in this case United, incurred an actual tax liability of 52 per cent.

Of course, viewed separately, each company having taxable income *contributes* 52 per cent of that income to the tax liability of the System, but if this implies a *separate assessment of tax* or *separate tax liability* equal to 52 per cent of the separate taxable income, it

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[17] In those years where only Cities Service Gas Company had taxable income the Tenth Circuit showed the consolidated tax, excluding that company, as a minus tax (i.e., a negative tax) which was used by the court to offset the taxable income it had computed for the Gas Company in order to get back to the starting point.

is in error. United is not assessed separately from the group and no group exists except the one which includes United. In order to file a consolidated return, every subsidiary in which the parent company owns 80 per cent or more of the stock must join in the return, and there is a single tax liability computed by adding up the taxable incomes of each company and offsetting against such taxable incomes the tax losses of other companies in the group. The tax liability is determined by applying the statutory tax rate to the resulting total net taxable income of the group. The consolidated tax return unites the participants for purposes of the tax computation and the equitable apportionment of the tax among them. No separate tax liability of each participant is computed. To be sure, each participant is severally liable for the consolidated tax liability, but there is never any application of the statutory tax rate to any participant's separate taxable income.

The fallacy of the Tenth Circuit's (and the Fifth Circuit's) mathematical exercise, which assumes the same tax liability for the group on a separate and consolidated basis, is easily demonstrated. Assume that four corporations join in a consolidated return and have separate taxable income or tax loss as follows:

Corporation	Taxable Liability (Tax Loss)
A	$20,000
B	10,000
C	5,000
D	(5,000)
Total net taxable Income	$30,000

At a 52 per cent corporate tax rate, the consolidated tax liability (52 per cent × $30,000) is $15,600.

If, however, the Tenth and Fifth Circuits' theory of a separate actual liability of 52 per cent for each participant in a consolidated tax return was valid, the income tax liability of Corporations A, B, C, and D would separately, and in total, be as follows:

A	$10,400 (52% of $20,000)
B	5,200 (52% of $10,000)
C	2,600 (52% of $5,000)
D	—0— (52% of zero taxable income)
Total Tax Liability	$18,200 (52% of $35,000)

Since the $18,200 exceeds the consolidated tax liability of $15,600, it is apparent that each participant with taxable income in the consolidated tax return does not *incur* a tax liability equal to 52 per cent of its taxable income; the theory of the Tenth and Fifth Circuit is fundamentally fallacious. The Tenth Circuit and the court below went astray because they did not compute a separate tax liability for each participant, add up those computations, and compare the summation to the consolidated tax liability.

The theory of the Fifth and Tenth Circuits could only produce a consolidated tax liability of $15,600 by assigning a "negative tax" of $2,600 to Corporation D. This, however, would neither be accurate nor realistic. The Bureau of Internal Revenue has ruled that no such "negative tax" allocation may be made. It held that the tax "should be apportioned among the members of the group in accordance with the ratio of that portion of the consolidated normal-tax net income attributable to each member of the affiliated group to the consolidated normal-tax net income, *leaving out of consideration any member of the group having no net income*" (italics supplied). Income Tax Ruling No.

4085, *Bureau of Internal Revenue Cumulative Bulletin 1952,* Vol. 1, p. 68.

Corporation D's tax loss position (here Union) cannot benefit anyone except its affiliates A, B and C (here United and Corporation). This is accomplished through a consolidated tax return as a result of which United's tax liability is less than its tax liability on a separate tax return basis.

Therefore, to the extent that the Fifth Circuit reversed the Commission's order on the premise that United incurred a tax liability equal to 52 per cent of its separate taxable income, which should have been allowed, the Fifth Circuit was in error.

IV.

THE COMMISSION'S ALLOCATION METHOD DID NOT EXCEED ITS STATUTORY AUTHORITY.

The Commission allocated the consolidated tax liability between United and Corporation on the basis of their respective taxable incomes. No allocation of the consolidated tax liability was made to Union since it had no taxable income.

This disposition of the consolidated tax liability was appropriate since tax liability is a function of taxable income and the rate. Since Union had no taxable income, no apportionment to it of the consolidated tax liability was appropriate.[18] On the other hand, since tax liability is a function of taxable income and the rate, the apportionment of the liability between United and Corporation on the basis of their respective taxable

[18] In fixing Union's rates to United, the Commission in a consistent manner took Union's federal income taxes at zero. *Union Producing Company,* 31 FPC 41, 49-50 (1964).

incomes was eminently fair. It was in accord with allocation methods authorized by the Internal Revenue Code for tax purposes by the consolidated group and by the Securities and Exchange Commission for its regulatory purposes. 26 U.S.C. § 1552; SEC Holding Company Act Regulations, Sec. 250.45(b)(6).

As shown above, the Commission did not thereby appropriate tax losses of unregulated and unrelated business for the benefit of regulated business since Union is a regulated and related business.

Moreover, this is not an appropriate test. The consolidated tax return is for the benefit of each participant. Indeed, the taxable incomes provide the assurance that the tax losses can be beneficially used to the full extent and to the full extent of their value. Whether or not the tax saving—benefit—of the consolidated tax return is the result of tax losses of unregulated and unrelated businesses, each participant having taxable income (here United and Corporation) is entitled to share in the benefit. The Commission's method in this case accomplished this in a fair and rational manner. To apportion a joint cost, neither segregation of properties or corporations is required. *Colorado Interstate Gas Company* v. *Federal Power Commission,* 324 U.S. 581, 588, 590-591 (1945).

CONCLUSION

WHEREFORE, for each and all of the reasons set forth in this brief the decision of the court below should be reversed and the Commission's orders affirmed.

Respectfully submitted,

REUBEN GOLDBERG
1250 Connecticut Avenue
Washington, D. C. 20036

GEORGE E. MORROW
Union Planters National Bank Building
Memphis, Tennessee 38103

Attorneys for Memphis Light, Gas and Water Division

September 1, 1966

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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 127

FEDERAL POWER COMMISSION, PETITIONER

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, AND TEXAS EASTERN TRANSMISSION CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (II R. 70–72)[1] is reported at 357 F. 2d 230. The opinion and order of the Federal Power Commission (II R. 32) are reported at 31 F.P.C. 1180. The Commission's decisions on the applications for rehearing are reported at 32 F.P.C. 687, 879, and 1163.

[1] The record in this Court consists of Joint Appendix, Volume I below, referred to herein as "I. R.," and Joint Appendix, Volume II below (as supplemented by the opinion of the court of appeals and other pleadings and documents in the court of appeals and in this Court), referred to as "II R."—the two volumes being bound together but paginated separately.

JURISDICTION

The judgment of the court of appeals setting aside the Commission's order was entered on February 10, 1966 (II R. 73–74). The petition for certiorari was filed on May 11, 1966, and granted on June 13, 1966 (II R. 75, 384 U.S. 984). The jurisdiction of this Court rests on 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

United Gas Pipe Line Company (United) is one of a group of affiliated corporations constituting an integrated gas utility system. The group files consolidated federal income tax returns. In the relevant period, the producing affiliates sustained tax losses while United (the transmission company) and the distributing company had substantial taxable income. By filing consolidated returns, and thus offsetting the tax losses of the producing members against the taxable income of United and the distributing affiliate, the group incurred a smaller tax liability than if each affiliate had filed a separate return. The question presented is whether the Federal Power Commission, in fixing United's rates, is nevertheless obliged to allow as a cost of service a tax allowance computed at the full separate-return rate.

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, June 21, 1938, c. 556, 52 Stat. 821–833, as amended, 15 U.S.C. 717–717w, and of the Internal Revenue Code of 1954, 68A Stat. 3, *et seq.*, as amended, 26 U.S.C. 1, *et seq.*, are set forth in Appendix A, *infra*, pp. 29–32.

STATEMENT

This case began as a proceeding before the Federal Power Commission under Section 4(d) of the Natural Gas Act (App. A, *infra*, p. 29) to test the reasonableness of certain rate increases put into effect by United Gas Pipe Line Company.[2] The increases were disallowed. So far as relevant here,[3] the Commission ruled that United had improperly included in its cost of service an allowance for federal income taxes computed at the separate-return rate. United in fact files consolidated returns with affiliated corporations, and the consolidated filing results in a lesser tax liability for the group of affiliates than if they filed separate returns. The court of appeals vacated the Commission's order on the reasoning of the Tenth Circuit in *Cities Service Co.* v. *Federal Power Commission*, 337 F. 2d 97,[4] ruling that United was entitled to have its cost-of-service tax allowance computed at the separate-return rate.

1. BACKGROUND

United is a major interstate natural gas pipeline company. Forty-four percent of its sales are within

[2] The other respondents in this Court are pipeline customers of United who intervened in the Commission proceeding. They also file consolidated returns.

[3] Other issues—unrelated to the treatment of the consolidated tax savings—pertaining to the reasonableness of United's rates were involved in the proceeding before the Commission. Petitions to review one such issue were dismissed in *Texas Eastern Transmission Corp.* v. *Federal Power Commission*, 357 F. 2d 232 (C.A. 5). The others were settled. 32 F.P.C. 1515.

[4] We have printed the Tenth Circuit's opinion in App. B, *infra*, pp. 33–39.

the rate jurisdiction of the Federal Power Commission (II R. 54). It is a wholly owned subsidiary of United Gas Corporation (Gas Corporation), a smaller company whose principal taxable income is derived from the operation of several local gas distribution systems in Texas, Louisiana and Mississippi. These systems are subject to State and municipal rate regulation. Gas Corporation also owns all of the stock of Union Producing Company (Union), a domestic producer of oil and gas whose interstate gas sales are subject to Federal Power Commission regulation, and United Overseas Production Corporation (Overseas), which engaged in foreign oil exploration.

Union, United, and Gas Corporation constitute an integrated gas utility system from wellhead to consumer's premises. Union sells approximately 80 per cent of the gas it produces to United, and United furnishes Gas Corporation (the distributing arm of the system) with approximately 96 percent of the latter's gas.[5] United is by far the largest company in the system. Its gross revenues in 1951 were $298 million. In the same year, Gas Corporation's gross operating revenues were $50 million and Union's $52 million.[6]

Gas Corporation and its wholly owned subsidiaries, including United, elect, pursuant to Section 1501 of the Internal Revenue Code of 1954, App. A, *infra*, pp. 29–30, to file consolidated federal income tax returns.

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[5] *Union Producing Co.*, 31 F.P.C. 41, 43–44; 1964 Annual Report of United Gas Corporation, p. 4 (on file with Federal Power Commission).

[6] Moody's Public Utility Manual (1962), p. 1368.

In these returns (which all affiliates must join),[7] the taxable transactions of the four members of the affiliated group are combined to produce a single net taxable income, upon which the tax is computed. In determining the consolidated net taxable income, any tax losses sustained during the taxable period by a member of the group are offset against the taxable income of the companies having taxable income in the same period.[8]

Between 1957 and 1961—the representative period selected by the Commission—the United system, filing consolidated returns, paid $57,199,881 to the government in income (excluding capital gains) taxes (II R. 53). Had separate returns been filed, the total tax for the four companies for the same period (excluding the taxes that would have been paid on inter-company dividends)[9] would have been $59,291,919. The differ-

[7] To be "affiliated corporations" at least 80 per cent of the voting stock of each company must be in common ownership. 26 U.S.C. 1504(a), App. A, *infra*, pp. 30–31. Here, of course, the common ownership is 100 percent.

[8] Income and expense items resulting from transactions among the affiliates are excluded in computing the taxable income of the consolidated group. Thus, dividends paid by affiliates are excluded from the income of the receiving company; interest paid to affiliates is treated as income to the receiving company and a deduction to the paying company, and so cancel out (I R. 93–94).

[9] In the period in question, 15 percent of all dividends received by corporations were taxable as ordinary income. Hence, if inter-affiliate dividends were large, the tax savings to the consolidated group in this respect alone were substantial. During the five-year period, Gas Corporation received $66,567,028 in dividends from United and Union, on which a tax of about $5

ence—more than $2 million—reflects the fact that in the consolidated returns the group was able to set off Union's net tax losses of $3,869,626 and the $24,434 net tax loss of Overseas [10] against the income of United and Gas Corporation. United's total taxable income in this period was $105,290,983 and Gas Corporation's $9,024,170 (II R. 53).

Although it had tax losses, Union made substantial profits and paid dividends each year between 1952 and 1961. Its net income during the relevant five-year period was almost $70 million. (II R. 4.) Its tax-loss status is attributable entirely to the deductions for depletion and for intangible drilling and development costs permitted by the Internal Revenue Code (see 26 U.S.C. 613, 263(c)).

2. THE COMMISSION PROCEEDING

On June 15, 1962, United filed revised rate schedules with the Federal Power Commission increasing its rates overall. After a hearing to determine the lawfulness of the increased rates, the Commission ordered them reduced.

One of the issues relating to the lawfulness of the increases was whether the Commission could test the

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million would have been due had separate returns been filed. This is not an important source of tax savings for the future, since Section 214 of the Revenue Act of 1964 permits the exclusion of 100 percent of dividends received from affiliates. 78 Stat. 52, 26 U.S.C. 243.

[10] Overseas did not commence operations until 1961 (II R. 24), and so far as we have been able to determine has been defunct since 1961. With an average loss for the test period of less than $5,000, its significance to the issues here is negligible.

reasonableness of United's rates against its cost of service without including in that cost (as United proposed) the full amount of federal income taxes United *would* pay if it paid at the standard rate for corporate taxpayers filing separate returns. On this point, the Commission followed the procedure that it had recently enunciated in *Cities Service Gas Co.*, 30 F.P.C. 158,[11] to calculate the effective tax rate applicable to United. Under this procedure, the Commission (1) separates the affiliated corporations into regulated and unregulated groups; (2) determines the net taxable income of each group; and (3) apportions the total consolidated tax liability during the test period between the two groups and then among the companies in the regulated group in proportion to their respective taxable incomes.[12]

Under this method, any losses sustained by an unregulated company or activity must first be set off against the total income of all unregulated operations. Since, however, the unregulated activities in the present case produced no net taxable income during the relevant period, this preliminary step became unnecessary. The consolidated tax actually paid by the system during the test period was simply allocated

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[11] Its order in that case was subsequently set aside by the Tenth Circuit. See p. 3, *supra*.

[12] In no event may "the allowance so computed for the regulated company * * * exceed what its tax liability would be for rate making purposes, if computed on a separate return basis" (*Cities Service*, *supra*, 30 F.P.C. at 164).

between the two profit companies, Gas Corporation [13] and United, in proportion to their taxable incomes (excluding capital gains) for the five years.

United's taxable income was 92.11 percent of the total. The percentage, applied to the system's average annual tax of $11,439,976 during the test period, yielded the amount ($10,537,362) deemed by the Commission to be United's fair share of the tax. This amount was 50.04 percent of United's average annual taxable income of $21,058,197. In the Commission's view, therefore, 50.04 percent—not 52 percent, the rate at which United would have paid federal income tax had it filed separate returns—was United's effective tax rate and the proper basis for determining United's test-year tax allowance for rate purposes (II R. 41–42, 53).

3. THE COURT OF APPEALS' DECISION

United filed a petition in the Court of Appeals for the Fifth Circuit to review the Commission's ruling, contending that it was entitled to compute its federal income tax allowance for rate-making purposes at the separate-return rate. The court of appeals agreed and vacated the Commission's order. In a brief opin-

[13] We point out that, in regulating Gas Corporation's rates, the State of Mississippi does not require that consolidated-return savings be reflected in the rates. *Mississippi Public Service Commission* v. *Southern Bell Tel. & Tel. Co.*, 16 P.U.R. 3d 415, 454 (Miss. P.U.C.). Louisiana and Texas, however—the other States that regulate Gas Corporation's distributing operations—evidently do. See *Ex Parte Southern Bell Tel. & Tel. Co.*, 26 P.U.R. 3d 55, 110–111 (La. P.S.C.); *State* v. *Lone Star Gas Co.*, 86 S.W. 2d 484, 503, 11 P.U.R. (N.S.) 283, 311 (Tex. Ct. Civ. App.); but see *San Antonio Transit Co.* v. *City of San Antonio*, 323 S.W. 2d 272, 275 (Tex. Ct. Civ. App.).

ion (II R. 70–72), it adopted the reasoning of the Tenth Circuit in *Cities Service Gas Co.* v. *Federal Power Commission*, 337 F. 2d 97 (App. B, *infra*, pp. 33–39). Neither opinion is addressed to the particulars of the Commission's allocation method—the three-step procedure described above. Both find the Commission powerless to make *any* allocation, and hold that United was entitled to have federal income tax included in the cost of service used to test the reasonableness of its rates at the full 52-percent rate for separate corporate returns. The Tenth Circuit stated (337 F. 2d at 100, App. B, *infra*, p. 37):

> We think it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent Company. This approach cannot be justified by the actualities of the case. The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52 percent rate, but its tax liability at that rate was reported to the parent Company, and the consolidated returns actually reflect that tax liability.

SUMMARY OF ARGUMENT

The court below held that where an integrated gas utility system files consolidated federal income tax returns, in which the tax losses of the producing affiliates are offset against the taxable income of the transmission and distributing members, no part of the resulting tax savings may be allocated for rate-making purposes to the transmission company (United), even though that company contributed the

principal portion of the system's taxable income. The court reasoned that the profit members of the group made no contribution to the savings and that therefore their ratepayers should not share that benefit in the form of lower rates.

I.

The court's reasoning, we submit, distorts economic realities and is contrary to sound principles of public utility regulation.

A. In no meaningful sense were the tax savings attributable exclusively to the tax-loss corporations. A tax loss in itself gives rise to no tax benefit. For such a benefit to result, there must also be taxable income against which to offset the loss. That indispensable condition was largely created here by United—and its ratepayers. It is they who assure the steady profits necessary to take advantage of the producing companies' tax losses.

B. United's ratepayers also made a direct and substantial contribution to the operations giving rise to those losses. The business of the producing company in which nearly all the losses were sustained—United—is only nominally separate from the pipeline and distributing operations of the integrated system. As a regulated public utility enjoying a quasi-monopolistic position, United gives the system an assured source of substantial profits. This in turn facilitates additional ventures like oil and gas exploration, both by providing a substantial cushion against the risk of loss in those undertakings and by guaranteeing that any tax losses incurred in them can be converted immedi-

ately into a cash savings in federal income taxes by filing consolidated returns. The presence of a pipeline company of United's magnitude in an integrated system also facilitates the raising of venture capital on advantageous terms. United contributes additional support to the producing companies' operations by providing an assured market for their gas output.

It is also relevant that the tax losses of the producing companies were not business losses in the sense that there was an excess of expenses over revenues. By virtue of generous allowances available to the oil and gas industry, the producing companies enjoyed business profits and tax losses. Since the stockholders did not suffer impairment of their capital or earnings because of these tax losses—which were wholly benign—it can hardly be said that a reasonable allocation of the tax savings operates harshly upon investors.

II.

The result we urge is consistent with the relevant provisions of the Internal Revenue Code. Contrary to the view of respondents, the Code does not provide that tax liability at the separate-return rate continues when the taxpayer joins in a consolidated return. Moreover, the only purpose of the consolidated-return privilege is to recognize that a group of affiliated corporations is, despite its corporate form, a single business entity. This precept is not impaired by an allocation of consolidated tax savings among the member corporations—a procedure the Code expressly recognizes. Certainly, in permitting consolidation, Congress had no intention of precluding the Federal

Power Commission from applying normal regulatory principles to the corporations within its rate-making jurisdiction.

ARGUMENT

INTRODUCTION

In testing the reasonableness of the rates of a natural gas pipeline company, the Federal Power Commission follows traditional public utility rate-making principles, under which the company's stockholders are entitled to a fair return—no more and no less—on their investment. Sound application of this rule obviously depends upon an accurate ascertainment of the costs incurred by the company in providing the service for which the rate is to be fixed. And since the focus is on the yield to the stockholders rather than on the operating profits of the company, federal income taxes paid by the company are treated as an item of cost of service.

Determination of the cost of providing a particular service is often difficult, especially where the service is provided by a diversified business entity. Unless the pipeline operations subject to the Commission's rate jurisdiction are completely segregated from the concern's other operations, it may be improper to assign the whole of a particular expense to either pipeline cost of service or non-pipeline operations. Examples of such an expense—or "joint cost"—would be rent paid by the concern for occupancy of a building housing both pipeline and nonpipeline employees and the salary it pays its comptroller who keeps all the books of the concern. If the true pipeline cost of serv-

ice is to be determined, such an expense item must be allocated between pipeline and non-pipeline operations in accordance with business reality. See *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, 586–589. If, in our examples, rent and salary are assigned wholly to pipeline operations, and their full amount included in the pipeline cost of service, the ratepayers will be defraying an expense part of which was not incurred in providing them with pipeline service; they will be subsidizing other business ventures of the company. If, on the other hand, rent and salary are assigned wholly to non-pipeline operations, the stockholders will be prevented from recouping in full the actual cost of providing pipeline service to the ratepayers.

The need for allocation is equally clear with respect to *savings* in joint costs. Suppose the landlord refunds a portion of the rent, or the comptroller returns a portion of his salary because it was paid by mistake. If the entire amount is credited to pipeline cost of service and thus passed through to the ratepayers, they receive a partial windfall—the benefit of a reduction in a cost partly incurred in another business venture the expenses of which were not defrayed by the ratepayers in the first place.[14] On the other hand, if no part of the reduction in cost is credited to pipeline cost of service, the stockholders will receive a rebate of an expense which the ratepayers originally bore.

[14] This assumes, of course, that the rent or salary originally was properly allocated between pipeline and non-pipeline operations.

The present case involves a specific application of these settled principles of cost allocation. United Gas Pipe Line Company is a member of a group of affiliated corporations which files consolidated federal income tax returns. In the relevant period, United furnished most of the taxable income of the group. Other members—companies engaged in oil and gas production—sustained sizable tax losses. By filing consolidated returns, the group was permitted by the Internal Revenue Code to offset the tax losses of the producers against the taxable income of the other members, resulting in lower taxes than if each member had filed separate returns. The issue is whether it is improper for the Commission to allocate any part of the tax savings to United as a reduction in its cost of service. Stated otherwise, it is whether United is entitled to include in its cost of service the full measure of federal taxes it would have paid had it filed separately; if so, no part of the tax savings obtained by the consolidated filing in which United participated will inure to the benefit of its ratepayers. The Commission, with one exception, has been consistent in requiring allocation in these circumstances. *Home Gas Co.*, 13 F.P.C. 241, 246; *United Fuel Gas Co.*, 12 F.P.C. 251, 264–265; *Hope Natural Gas Co.*, 10 F.P.C. 625; *Penn-York Natural Gas Corp.*, 5 F.P.C. 33, 38–39; but see *Olin Gas Transmission Corp.*, 17 F.P.C. 685.

We emphasize that the issue is a clear-cut one—allocation *vel non*. The proper formula of allocation—

how much of the tax savings is to be assigned each member of the group—is not an issue here. The court below did not criticize the particular formula utilized by the Commission (which, as applied to the facts of this case, results in allocating the whole of the savings to the companies that had taxable income). The court held, rather, that the Commission was without power to make *any* allocation; all of the savings must go to the loss companies.[15]

This position might have considerable cogency if the tax savings were indeed wholly attributable to the non-pipeline operations of the consolidated group, and if, in addition, those operations were in nowise supported by the pipeline operations. As we shall show, neither condition obtains. United—and its ratepayers—play a vital role in the conversion of the system's tax losses into a positive financial benefit. And United—and its ratepayers—support, importantly albeit indirectly, the nominally separate activities (both regulated and unregulated) of the producing companies which give rise to the tax losses. Hence, allocation is clearly justified by sound regulatory principles. As we shall also argue, this result is not opposed to the policy and design of the relevant provisions of the Internal Revenue Code.

[15] This is the reasoning of *Cities Service Co.* v. *Federal Power Commission*, 337 F. 2d 97 (C.A. 10), App. B, *infra*, pp. 33–39, on which the court below, in its brief opinion, expressly relied.

I.

UNITED'S RATEPAYERS ARE ENTITLED TO SHARE IN THE TAX SAVINGS OBTAINED BY FILING CONSOLIDATED RETURNS; THEY PLAYED A CRUCIAL ROLE IN THE TRANSFORMATION OF TAX LOSSES INTO TAX BENEFITS AND THEY CONTRIBUTED MATERIAL SUPPORT TO THE ACTIVITIES IN WHICH THE LOSSES WERE SUSTAINED

A. THE MEMBERS OF THE CONSOLIDATED GROUP WHO—LIKE UNITED—HAD TAXABLE INCOME WERE INDISPENSABLE TO THE REALIZATION OF TAX SAVINGS FROM THE TAX LOSSES OF THE PRODUCING COMPANIES

By filing consolidated federal income tax returns under Section 1501 of the Internal Revenue Code, the United gas system was able to set off the tax losses of the producing affiliates (principally Union) against the taxable income of the transmission and distribution affiliates (United and Gas Corporation). H[illegible] the members of the consolidated group filed separate returns all of the system's taxable income would have been taxed. The tax savings produced by the consolidated filing was more than $2 million in the relevant period.

1. Without tax losses to set off against taxable income, there would, of course, have been no tax benefit to be obtained by filing consolidated returns. Equally, however, without taxable income the tax losses could not have been translated into tax savings. If United and Gas Corporation had not had any taxable income, the group would not have received, as it did, the equivalent of a $2 million rebate as a result of the producing members' losses. And since the income was

very largely contributed by United's ratepayers,[16] we submit that they are entitled to share in the resulting tax benefit. Stated otherwise, since federal income tax is a cost of service that the customers of a regulated utility defray in the rates they pay, a tax reduction that is at least partly attributable to the taxpayer's regulated operation should be applied, at least partly, to reducing those rates.

It is relevant in this connection that United and Gas Corporation—the members of the consolidated group that furnished all of its taxable income—are both regulated public utilities. The profitability of these franchised monopolies is virtually guaranteed; constitutional requirements apart, it is a guiding principle of public utility regulation to avert any impairment of the regulated company's financial soundness. The value of the consolidated-return device as a method for obtaining tangible monetary benefits from tax losses is, thus, substantially enhanced when the affiliated group includes a natural gas pipeline company of United's magnitude. Such a group is virtually certain to have a steady source of profits (the *sine qua non* of benefiting from filing consolidated returns) large enough to cover its tax losses. The ultimate source of the profits—the guarantors, as it were, of the tax savings—are United's ratepayers.

2. It is no answer to say that United did not contribute to the tax savings because Gas Corporation's taxable income was sufficient in itself to cover the pro-

[16] United provided more than 90 percent of the system's income. Statement, *supra*, p. 8.

ducing companies' losses and so enable the savings to be realized. It is completely arbitrary to regard Gas Corporation as having made the decisive contribution. One could argue with equal force that United (which had the bulk of the system's taxable income) furnished the necessary income to cover the losses and that Gas Corporation's income was superfluous—an argument which would require that, as between United and Gas Corporation, the savings be allocated wholly to the former. Sound economics requires the conclusion that each contributed *pro rata*.

Section 1501, moreover, expressly requires each member of an affiliated group to join in the consolidated return, and the benefits of the device are forfeited if the income of any member is omitted (26 C.F.R. 1-1502-18). The group thus could not have elected to exclude United from the consolidated filing.

Nor is it an answer that, in light of the loss carry-back and carry-forward provisions of the Code,[17] the tax losses sustained by the producing companies might conceivably have given rise to tax savings even if separate returns had been filed. These provisions depend upon the loss corporation's having taxable income within the prescribed time periods sufficient to absorb the losses, and there is no indication that these are likely contingencies for the producing members of the United system.[18] Moreover, an affil-

[17] 26 U.S.C. 172 permits a corporation to offset tax losses against taxable income earned within three years before or five years after the losses were sustained.

[18] There is no contention that the five-year period utilized by the Commission in determining the average tax liability of United is not representative.

iated group that elects to file consolidated returns loses the right to utilize the carry-back and carry-forward provisions for its individual members (26 C.F.R. 1-1502-31(a)(2)-(5), -31(b)(2)(iv)). The group thus must choose which method of offsetting tax losses against taxable income—separate filing with loss carry-back or carry-forward by individual members or consolidated filing—is the more advantageous method for it.

The group of which United is a member has chosen the latter; it has decided that the savings will be greater by offsetting the tax losses of its producing members against the assured income of United and Gas Corporation than by speculating on the prospects for taxable income of the producing companies. In these circumstances, the contention that the consolidated-return device is not necessary to reap the full tax benefit of the group's tax losses is decidedly unpersuasive.

B. THE OPERATIONS IN WHICH THE TAX LOSSES WERE SUSTAINED WERE SUPPORTED IN A MEANINGFUL SENSE BY UNITED'S RATEPAYERS

Above, we considered the question of allocation of tax savings from the standpoint of whether United's ratepayers could realistically be said to have contributed to the conversion of the tax losses into an affirmative monetary benefit. There is, however, an additional dimension to the allocation problem. Since the tax savings which result from permitting businessmen to offset losses against income in computing their tax liability would appear designed for the benefit of the business entity as a whole—in this case, the United gas

utility system[19]—it is relevant to consider to what extent, if any, United's ratepayers may have supported the ventures in which the losses were sustained. If in a realistic sense the tax-loss ventures are at least partly theirs, there is additional basis for the Commission's conclusion that, for rate-making purposes, they should share in a tax benefit arising from those ventures. We submit that there is indeed a substantial interrelation between the group's pipeline operations—supported by United's ratepayers—and its tax-loss production activities.

1. The steady stream of substantial profits that the pipeline operations assure (see p. 17, *supra*) furnishes an important cushion against entrepreneurial risks—and hence a significant incentive for diversification into related fields like oil and gas production. The virtual certainty of large-scale profits from the pipeline guarantees both that losses from new ventures will be absorbed without impairing the stockholders' investment[20] and that their adverse impact will be mitigated through realization of the maximum tax savings made possible by the filing of consolidated returns.[21] The assurance of profitable pipeline oper-

[19] This principle holds whether the taxpayer is a single corporation or an affiliated group filing a consolidated return. As will appear, the purpose of the consolidated-return device was simply to eradicate artificial distinctions in tax treatment based on corporate form (see pp. 25–27, *infra*).

[20] The stockholders of Union and Overseas are the same as the stockholders of United and the parent company, Gas Corporation.

[21] The tax consideration is particularly important as an incentive to engage in oil and gas production, a field where substantial tax losses are commonly conjoined with large business profits (see p. 23, *infra*).

ations rests ultimately with United's ratepayers, who under the regulatory scheme are obliged to pay rates high enough to ensure a fair return to the pipeline's investors. The ratepayers are thus in effect underwriters of the investors' ventures.

There are additional dimensions to this participation. A large and profitable public utility system can raise capital for new enterprises on favorable terms; we point out in this connection that Union's entire capital has been furnished by the parent company of the system. *Union Producing Co.*, 31 F.P.C. 41, 47. Moreover, Union is a producer of both gas and oil, and its position as a gas producer is much strengthened by its affiliation with United. In United, Union has an assured market for its gas; and since its rates to United are fixed by the Commission so as to cover its cost of service plus a fair return on investment (*Union Producing Co., supra*), its costs (save in the unlikely event that they are deemed improvident by the Commission) are ultimately borne by United's ratepayers. The involvement of the ratepayers in the group's gas-production operations is thus appreciable. It is well recognized that the problems and risks for a gas producer lacking this kind of affiliation are greater. See *Southern Natural Gas Co.*, 29 F.P.C. 323, 336. Also, oil and gas production are intertwined; the two are commonly found together and producers frequently explore for them simultaneously. The backing that United's ratepayers supply Union's gas business perforce contributes to Union's oil ventures, where some of the tax losses (how much the record does not disclose) were sustained.

The short of it is that in an integrated system the pipeline company contributes substantially to the production end of the business. United's ratepayers were in effect partners of the system's investors in the gas and oil operations that gave rise to the tax losses and the resulting tax benefit. We need not go so far as to suggest that, as "partners," the ratepayers were entitled to share in the profits produced by the oil operations.[*] But since they did contribute substantially to the producing ventures which occasioned the tax losses, we submit that for regulatory purposes the savings should be allocated between the system's pipeline and oil operations in order to reflect the economic realities of the situation."

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[*] Despite its tax losses, Union was a profitable company at all times relevant to this case. See Statement, *supra*, p. 6; *infra*, p. 23.

[**] For a comparable approach in a different context, see *South Carolina Generating Co.* v. *Federal Power Commission*, 261 F. 2d 915 (C.A. 4). The Commission in that instance had allowed the regulated company, which because of a high debt-to-capital ratio and resulting high interest deductions had a low taxable income, only a tax allowance computed at the separate-return rate. The parent corporation claimed that, because of the regulated company's high debt ratio, the parent had had to reduce its own debt ratio and interest deductions, producing a proportionate increase in its taxable income. The court of appeals refused to sustain the Commission, holding that there should be an allocation of the consolidated tax (261 F. 2d at 920): "* * * [A]ctual costs should not be disregarded simply because the selling utility chooses to incur them in one place rather than another. The additional income tax is an unavoidable consequence of the service [for which the rate in question is charged] and whether [the parent corporation] elects to incur that cost directly or only indirectly through its wholly owned subsidiary, the relation to the total cost of service is the same." See, also, *Southwestern Bell Tel. Co.* v. *Kansas State Corp. Comm.*, 192 Kan. 39, 71–72, 386 P. 2d 515, 543–544.

2. There is no merit to the argument that the investors bear the brunt of Union's potential business losses and therefore should receive the entire benefit of any mitigation of that risk. They would not bear the *full* brunt of such losses—and the only issue in this case, we stress, is whether *any* allocation to the pipeline cost of service is proper. Costs allocable to gas production, including those arising out of unsuccessful exploratory efforts, are passed through to United's ratepayers in the rates charged United by Union (see p. 21, *supra*). The ratepayers might also suffer to the extent that the system invested in Union's, activities. More pointedly, Union's tax losses are not true business losses. Union's oil operations are in fact highly profitable (see Statement, *supra*, p. 6). Its tax losses reflect the policy of Congress to encourage gas and oil exploration by percentage depletion and generous allowances for drilling expenses. The system's stockholders are not in the least hurt by these losses. They produce only benefits—benefits to which the pipeline ratepayers must be recognized as important contributors.

II.

NOTHING IN THE RELEVANT PROVISIONS OF THE INTERNAL REVENUE CODE PRECLUDES ALLOCATION HERE.

In Point I, we argued that allocation of the consolidated tax savings was, in the circumstances of this case, a necessary application of sound regulatory principles. It is also consistent with the relevant principles of federal tax law. The Internal Revenue Code discloses no purpose to preclude the Commission from

applying its usual regulatory standards to tax savings obtained by the filing of consolidated returns.

A. There is no merit to the suggestion that the Internal Revenue Code imposes on the profit members of an affiliated group a liability at the separate-return rate. The *only* tax liability of a corporation participating in a consolidated return is for the amount (for which each affiliate is severally liable) computed on a consolidated basis (see 26 U.S.C. 1503 (a); 26 C.F.R. 1.1502–15(a), –30, –31). There is no liability at the separate-return rate.[24] To show such a liability as a cost of service is thus, from a tax as well as a regulatory standpoint, wholly fictitious.[25]

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[24] Thus, when a consolidated return is filed, "the tax shall be determined, computed, assessed, collected, and adjusted" on the consolidated-return basis (26 U.S.C. 1503(a)) and the consolidated-return liability may not be reduced by any agreement entered into by any members of the affiliated group (26 C.F.R. 1.1502–15(d)). In addition, the parent corporation generally is required to act as the sole agent for the affiliated group in filing the return and dealing with the Internal Revenue Service (26 C.F.R. 1.1502–16(a)). When the Tenth Circuit in *Cities Service* spoke of a "tax liability" of the regulated company "at the statutory 52 percent rate" as being "reported to the parent Company" (App. B, *infra*, p. 37), it was presumably referring to the transmittal of the initial computation prepared by the regulated company to the parent corporation. That, however, is no more than inter-company correspondence necessary to enable the parent to carry out its duties as agent. The initial computations are not the return (see 26 C.F.R. 1.1502–30(a), 1.1502–31, 1.1502–31(a)(1), 1.1502–31(b)(1), 1.1502–31(b)(2)).

[25] United seeks a tax allowance of 52 percent of its taxable income as separately computed, which would amount to $54,743,026. Under this theory, Gas Corporation likewise would recover reimbursement from its consumers computed at 52 percent of its own taxable income, which would be $4,548,894 for

Cf. *El Paso Natural Gas Co.* v. *Federal Power Commission*, 281 F. 2d 567, 573 (C.A. 5), certiorari denied *sub nom. California* v. *Federal Power Commission*, 366 U.S. 912.

B. There is no basis in the Code for an inference that the consolidated-filing privilege is designed exclusively to benefit the affiliates having tax losses. Were that the scheme, the statute (26 U.S.C. 1501) would not permit, as it does, any member of an affiliated group to block the filing of a consolidated return by withholding its consent. *Western Pacific R.R. Corp.* v. *Western Pacific R. Co.*, 197 F. 2d 994, 1003 (C.A. 9), reversed on other grounds, 345 U.S. 247. In point of fact, the Code expressly authorizes allocation, by a formula similar to that applied by the Commission here, for purposes of determining the earnings and profits of each affiliate. 26 U.S.C. 1552 (a)(1).[26]

C. The basic purpose of the consolidated-return privilege is simply to permit (at the option of the

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the same period. Thus the two companies together would claim $59,291,919, even though the consolidated taxes actually paid by the system for the test period were only $57,199,880.

[26] The United system has elected to follow this method. Thus, the corporate books on which the members report to their stockholders show that, of the actual consolidated tax of $57,386,940 for the 5-year test period (not adjusted for capital gain), the system allocated $51,385,509 to United, which is less than 49% of its taxable income as separately computed for that period (I R. 98–100):

"Year	Consolidated Tax	Allocation		
		Corporation	United	Union
1957	$13,560,947	$1,311,344	$12,249,603	0
1958	16,188,431	2,188,676	13,999,755	0
1959	11,373,289	1,400,049	9,973,220	0
1960	8,265,382	1,101,382	7,164,020	0
1961	7,998,991	0	7,998,911	0
Total	$57,386,940	$6,001,431	$51,385,509	0"

affiliated group) piercing the corporate veil and "taxing as a business unit what in reality is a business unit" (S. Rep. No. 617, 65th Cong., 3d Sess., p. 9). "The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise." S. Rep. No. 960, 70th Cong., 1st Sess., p. 14. To like effect, see, *e.g.*, *Burnet* v. *Aluminum Goods Co.*, 287 U.S. 544, 547; H. Rep. No. 704, 73d Cong., 2d Sess., p. 17; H. Rep. No. 1337, 83d Cong., 2d Sess., p. 87; H. Rep. No. 749, 88th Cong., 1st Sess., pp. 116, A186; S. Rep. No. 830, 88th Cong., 2d Sess., p. 148; *id.*, pt. 2, p. 265. The natural-gas industry has so read the legislative intent. Hearings on General Revenue Revision before the House Committee on Ways and Means, 83d Cong., 1st Sess., p. 1280.

Congress, in other words, desired to permit equal tax treatment between concerns that transact business through departments of a single corporation and those operating through subsidiary corporations. This purpose is neutral with respect to how a tax savings resulting from setting off tax losses against taxable income is to be allocated within the business enterprise for rate-making purposes. There is not the slightest indication that Congress has ever desired to trench upon the Federal Power Commission's regulatory powers in this respect. A general tax provision like Section 1501 is hardly an apt tool for resolving the

intricate and technical problems involved in the issue whether a pipeline's ratepayers are entitled to share (in the form of lower rates) in a tax savings occasioned by the system's losses in the producing end of the oil and gas business. These are problems of utility regulation, not taxation. We submit that it was no part of Congress' purpose in permitting the filing of consolidated returns to decide whether allocation of the resulting savings is required to carry out the purposes of the Natural Gas Act.

To be sure, Congress desired that a business entity which sustained losses in one of its affiliated operations should be allowed to translate them into tax savings to the extent it had taxable income (see p. 20, *supra*). It is also true that Congress, in granting generous tax allowances for depletion and drilling costs, desired to encourage oil and gas exploration and development. However, an allocation of the benefits as between investors and ratepayers of an integrated system to reflect their respective contributions to the enterprise does not impair these purposes. The system benefits from the tax savings, as Congress intended, whether the savings inure directly to the investors or whether they are reflected in lower rates which attract new business and improve the system's competitive position. See *El Paso Natural Gas Co.* v. *Federal Power Commission*, 281 F.2d 567, 571, certiorari denied *sub nom. California* v. *Federal Power Commission*, 366 U.S. 912.

CONCLUSION

The judgment below should be reversed.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

RALPH S. SPRITZER,
RICHARD A. POSNER,
Assistants to the Solicitor General.

RICHARD A. SOLOMON,
General Counsel,

HOWARD E. WAHRENBROCK,
Solicitor,

ABRAHAM R. SPALTER,
Assistant General Counsel,

CYRIL S. WOFSY,
Attorney,
Federal Power Commission.

SEPTEMBER 1966.

APPENDIX A

The Natural Gas Act, June 21, 1938, c. 556, 52 Stat. 821–833, as amended, 15 U.S.C. 717–717w, provides in pertinent part:

> SEC. 4. (d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. * * *
>
> (e) Whenever any such new schedule is filed the Commission shall have authority * * * to enter upon a hearing concerning the lawfulness of such rate * * *. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the nautral-gas company * * *.

The Internal Revenue Code of 1954, 68A Stat. 3, *et seq.*, as amended, 26 U.S.C. 1, *et seq.*, provides in pertinent part:

> § 1501. Privilege to file consolidated returns.
>
> An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return

shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. * * *

§ 1502. Regulations.

The Secretary or his delegate shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. * * *

§ 1503. Computation and payment of tax.

(a) GENERAL RULE.—In any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under section 1502 * * *.

* * * * *

§ 1504. Definitions

(a) DEFINITION OF "AFFILIATED GROUP".—As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned

directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

* * * * *

(b) DEFINITION OF "INCLUDIBLE CORPORATION".—As used in this chapter, the term "includible corporation" means any corporation except—

* * * * *

§ 1552. Earnings and profits.

(a) GENERAL RULE.—Pursuant to regulations prescribed by the Secretary or his delegate the earnings and profits of each member of an affiliated group required to be included in a consolidated return for such group filed for a taxable year beginning after December 31, 1953, and ending after the date of enactment of this title, shall be determined by allocating the tax liability of the group for such year among the members of the group in accord with whichever of the following methods the group shall elect in its first consolidated return filed for such a taxable year;

(1) The tax liability shall be apportioned among the members of the group in accordance with the ratio which that portion of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income.

(2) The tax liability of the group shall be allocated to the several members of the group on the basis of the percentage of the total tax which the tax of such member if computed on a separate return would bear to the total

amount of the taxes for all members of the group so computed.

(3) The tax liability of the group (excluding the tax increases arising from the consolidation) shall be allocated on the basis of the contribution of each member of the group to the consolidated taxable income of the group. Any tax increases arising from the consolidation shall be distributed to the several members in direct proportion to the reduction in tax liability resulting to such members from the filing of the consolidated return as measured by the difference between their tax liabilities determined on a separate return basis and their tax liabilities (determined without regard to the 2 percent increase provided by section 1503(a)) based on their contributions to the consolidated taxable income.

(4) The tax liability of the group shall be allocated in accord with any other method selected by the group with the approval of the Secretary or his delegate.

(b) FAILURE TO ELECT.—If no election is made in such first return, the tax liability shall be allocated among the several members of the group pursuant to the method prescribed in subsection (a)(1). * * *

APPENDIX B

United States Court of Appeals
Tenth Circuit

JULY TERM, 1964

No. 7538

CITIES SERVICE GAS COMPANY AND
CITIES SERVICE COMPANY, PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

ON PETITION TO REVIEW AN ORDER OF THE FEDERAL POWER COMMISSION

Harry S. Littman (*Conrad C. Mount, Jack Werner, George H. Hill, Jr., Melvin Richter* and *Richard Littell* with him on brief) for petitioners.

Richard A. Solomon (*Howard E. Wahrenbrock, Abraham R. Spalter* and *Cyril S. Wofsey* with him on brief) for respondent.

Before MURRAH, Chief Judge, and HILL, Circuit Judge, and ARRAJ, District Judge

MURRAH, *Chief Judge:* In an order of the Federal Power Commission approving a settlement of the rates charged by Cities Service Gas Company for

jurisdictional gas sales, the Commission reserved for future determination the Federal income tax allowance to be included in the cost of service underlying the approved settlement. This appeal is from a final order of the Commission determining that sole issue.

The stipulated settlement included as a part of the cost of service a tax allowance based upon the statutory corporate income tax rate of 52 percent applied to the agreed taxable income of the Gas Company for the test year 1958. And, that amount would be routinely granted as a cost of service but for the Gas Company's participation in consolidated returns filed by its parent, Cities Service Company.

Having elected to file consolidated returns under Section 1501, 26 U.S.C., Cities Service was required by Section 1504, 26 U.S.C., to include all affiliates in which it owns 80 percent or more of the stock. Under the consolidated returns the total tax liability was less than it would have been if each subsidiary had filed separate returns. The reduction in the total tax liability resulted from offsetting the losses incurred by certain nonregulated affiliates against the taxable income of all other affiliates; and the Commission determined a tax allowance which reflected th so-called "tax savings" effected by the consoli- ted returns. The decisive question is whether the Commission, in the exercise of its undoubted power to determine just and reasonable rates for jurisdictional gas sales, may, in these circumstances, take into account the losses of nonregulated and unrelated affiliates to calculate the tax allowance includible in the cost of service of a regulated company.

The Commission recognized the fundamental rate-making principle which requires a separation of regulated and nonregulated profits and losses in the determination of the tax allowance. And see *Colorado*

Interstate Gas Co. v. *F.P.C.*, 324 U.S. 581; *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 324 U.S. 635. In obedience to this principle, the majority of the Commission rejected its Staff's theory which determined the tax allowance by taking the ratio of the Gas Company's income to the total income of the profit-making companies and applying this percentage to the total tax liability. The Commission characterized this theory as possessing "a quality of artificiality and instability which renders it unsatisfactory for rate-making purposes."

The majority of the Commission also rejected the determinations and recommendations of its Examiner who discarded the Staff's theory in favor of the settlement allowance based upon the statutory 52 percent rate. The Examiner could find no authority to support the theory that "consumers of natural gas sold in interstate commerce should have the benefit of 'tax savings' derived from business losses of unregulated corporations whose business activities are entirely unconnected with and dissimilar to those of the regulated natural gas company transporting and selling such gas."

Proceeding on the established premise that only actual costs—hence actual taxes—are properly includible in a rate base, a majority of the Commission held that the consolidated income tax liability is the "only real cost which was incurred by Gas Company in conjunction with the other Cities Service affiliates", and that to accept the Gas Company's approach based upon the statutory 52 percent rate would have the effect of determining jurisdictional rates "on the basis of converting a hypothetical tax payment into a prudent operating expense."

To comply with the rate-making principle of separating regulated and nonregulated profits and losses, and in conformity with the equally controlling actual

cost concept, the majority of the Commission devised a "method to be applied in computing the Federal income taxes to be included in the cost of service of a regulated company where the company has joined in a consolidated tax return with affiliates * * * (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate-making purposes, if computed on a separate return basis."[1]

As the basis for the application of this formula, the majority first selected the consolidated returns filed for the years 1957, 1958 and 1959. After separating the affiliates into regulated and nonregulated groups, the Commission determined that during the pertinent period the nonregulated companies had no net taxable income and that no tax liability should therefore be assigned to that group. The total taxable income of the regulated affiliates, which included companies regulated by other Federal and State agencies[2], was deter-

[1] One Commissioner would have adopted the Staff's theory but reluctantly joined two Commissioners in applying the above described method in order to form a working majority. The other two Commissioners dissented, contending that the Examiner's recommendations should be adopted. The dissenters were of the opinion that "Apart from the fact that there are no tax savings attributable to the inclusion of Gas Company in the consolidated return, the majority view is unlawful because it has the effect of regulating nonutility enterprises beyond the Commission's jurisdiction."

[2] Included by the Commission in the so-called "regulated" group, in addition to the Gas Company, are Cities Service Pipe Line Co., and Lafitte Oil Traders, Inc., both subject to regula-

mined to be $61,652,662, of which the Gas Company's share was 67.93 percent. This percentage was then applied to the normalized consolidated tax liability of all affiliates, an average of $8,636,607 a year, to arrive at the tax allowance of $5,866,847. The stipulated settlement had provided for a tax allowance of $7,055,981 based upon the statutory rate of 52 percent of the net separate taxable income of the Gas Company in 1958. The difference between these two sums is the bone of contention.

We think it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent Company. This approach cannot be justified by the actualities of the case. The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52 percent rate, but its tax liability at that rate was reported to the parent Company, and the consolidated returns actually reflect that tax liability.

Thus the consolidated return for 1957 shows a consolidated tax liability of $12,251,639 paid by Cities Service. If the Gas Company had filed a separate return, the consolidated tax liability would have amounted to $6,391,241, and the Gas Company's tax would have been $5,860,398 based upon the statutory 52 percent rate. The sum of these amounts precisely equals that which was actually paid by Cities Service. From this it is demonstrably clear that the inclusion

---

tion by the Interstate Commerce Commission, and Kansas Gas Supply Company, subject to regulation by the Kansas Commission. Also included in this group is that portion of the income of Cities Service Gas Producing Co. and Cities Service Oil Co.—Delaware—subject to regulation by the Federal Power Commission. These companies, however, are primarily engaged in the wholly unregulated oil business.

of the Gas Company in the consolidated return increased the consolidated tax liability by 52 percent of the Gas Company's taxable income. No "tax savings" resulted from the inclusion of the Gas Company in the consolidated return.

Similarly, in both 1958 and 1959 the inclusion of the Gas Company in the consolidated returns directly affected the consolidated tax liability in the amount of 52 percent of the Gas Company's taxable income, notwithstanding the fact that in those years the other Cities Service affiliates had aggregate tax losses. Application of the loss carry-back provisions of the Internal Revenue Code permit the offsetting of these losses against the taxable income of these affiliates in 1955 and 1956,[3] thereby resulting in tax refunds. No reduction in the actual total tax liability was thus effected since the net effect of the inclusion of the Gas Company in the 1958 and 1959 consolidated returns was to reduce the refund by 52 percent of the Gas Company's taxable income. See table below.[4] The simple fact is that the tax liability of the Gas Company as reflected in the consolidated returns was not hypothetical, but an actual cost to the Gas Company.

We know, of course, that the Commission is free to choose most any method which it deems appropriate

[3] The regulations promulgated pursuant to § 1502, 26 U.S.C. provide in accordance with § 172, 26 U.S.C. that a net loss in any year can be carried back to the three preceeding years or carried forward to the succeeding five years. 26 C.F.R. Part 1, § 1.1502-31(a)(4).

[4] See the following table:

"Year	(1) Consolidated Tax (including Gas Company)	(2) Consolidated Tax (excluding Gas Company)	(3) Gas Company's Separate Tax	(4) Sum of (2) plus (3)
1957	$12,251,639	$9,391,241	$5,860,398	$12,251,639
1958	(3,857,122)	(12,724,656)	6,867,534	(3,857,122)
1959	2,965,014	(5,966,531)	8,931,545	2,965,014"

in the determination of just and reasonable rates for jurisdictional gas sales,—usually a legitimate end justifies the means. See; *Colorado Interstate Gas Co.* v. *F.P.C., supra; Panhandle Eastern Pipe Line Co.* v. *F.P.C., supra; Wisconsin* v. *F.P.C.*, 373 U.S. 294. But, we know equally well that the method utilized must surely be within acknowledged jurisdictional limits which require an effective separation of regulated and nonregulated activities for the determination of the ingredients of the rate base. As applied to our case, it means a separation of profits and losses between regulated and nonregulated businesses in determining the tax allowance includible in the cost of service of the regulated company. "Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which Congress wrote into the Act." *Panhandle Eastern Pipe Line Co.* v. *F.P.C., supra,* p. 641.

And, as we have seen, the total tax liability is not affected when the Gas Company's tax liability at the 52 percent rate is included in the consolidated returns. Rather, the reduction in the total tax liability effected by the consolidated returns is due to the losses of the nonregulated companies. But, even so, under the Commission's method, the tax allowance of the Gas Company is made to depend upon the profits or losses, as the case may be, of the nonregulated companies.

It is thus plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the Act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

Nos. 127, 128

FEDERAL POWER COMMISSION, MEMPHIS LIGHT, GAS AND WATER DIVISION, *Petitioners,*

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, AND TEXAS EASTERN TRANSMISSION CORPORATION, *Respondents.*

On Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF OF INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA, AMICUS CURIAE, IN SUPPORT OF RESPONDENTS

This brief, *amicus curiae,* is filed with the consent of the parties.

INTEREST OF AMICUS CURIAE

Independent Natural Gas Association of America (INGAA) is a non-profit trade association whose membership includes most of the interstate natural gas pipeline companies subject to the jurisdiction of the

Federal Power Commission (Commission).[1] For many years INGAA has appeared in rule-making, rate and certificate proceedings before the Commission involving issues affecting the natural gas industry generally. It has participated in proceedings before this Court and the various Federal appellate courts in cases arising out of Commission action.

Since many natural gas pipeline companies are engaged in non-jurisdictional operations directly or through affiliates, it is manifest that INGAA's member companies have an important interest which may be affected by this Court's action in the instant proceeding.

OPINIONS BELOW

The opinion of the court of appeals (II R. 70-72)[2] is reported at 357 F. 2d 230. The opinion and order of the Commission (II R. 32) are reported at 31 F.P.C. 1180. The Commission's decisions on the applications for rehearing are reported at 32 F.P.C. 687, 879, and 1163.

JURISDICTION

The judgment of the court of appeals setting aside the Commission's order was entered on February 10, 1966 (II R. 73-74). The petitions for certiorari were filed on May 11, 1966, and granted on June 13, 1966

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[1] For convenience United Gas Pipe Line Company is referred to as United; Union Producing Company as Union; United Gas Corporation as Gas Corporation; and United Overseas Production Corporation as Overseas.

[2] The record in this Court consists of Joint Appendix, Volume I below, referred to herein as "I.R.," and Joint Appendix, Volume II below (as supplemented by the opinion of the court of appeals and other pleadings and documents in the court of appeals and in this Court), referred to as "II R."—the two volumes being bound together but paginated separately.

(II R. 75-76, 384 U.S. 984). The jurisdiction of this Court rests on 28 U.S.C. 1254 (1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

When a company making sales of natural gas subject to rate regulation by the Commission under the Natural Gas Act joins in a consolidated Federal income tax return with affiliates which have net tax losses in connection with unrelated and non-jurisdictional (non-utility) activities, may the Commission reduce the income tax allowance used in computing the rates for sales subject to its jurisdiction by utilizing all or part of such unrelated and non-jurisdictional tax losses?

STATUTES INVOLVED

The pertinent provision of the Natural Gas Act, 52 Stat. 821-833, as amended, 15 U.S.C. 717-717w, and of the Internal Revenue Code of 1954, 68A Stat. 3 *et seq.*, as amended, 26 U.S.C. 1, *et seq.*, are set out in Appendix A to the Brief in No. 127.

STATEMENT

In order to avoid repetition, we adopt the statements of facts set out in the briefs of respondents.

SUMMARY OF ARGUMENT

Although Petitioners' *briefs*[3] would leave the impression that the tax losses here involved pertained to Union's jurisdictional, *i.e.* gas production business, the Commission's *opinion* under review makes it clear that these tax losses stemmed from non-jurisdictional, *i.e.* oil, operations unrelated to United's jurisdictional gas

[3] Emphasis supplied throughout unless otherwise noted.

sales. Thus, the question presented concerns the propriety of appropriating the benefits of such *non-jurisdictional* losses to reduce United's jurisdictional rates.

Since the Commission now acknowledges that in its opinion under review it appropriated *all* the benefits of these non-jurisdictional (oil) tax losses for United's so-called jurisdictional activities and that such appropriation goes too far, the Commission's request for reversal of the judgment below improperly seeks reinstatement of an admittedly erroneous Commission order. Moreover, the sharing theory underlying this request played no part in that Commission opinion and so, under established principles, is not now available to support the Commission's action. *E.g. S.E.C.* v. *Chenery Corp.*, 318 U.S. 80, 87-88 (1943). In any case, since the new theory, even if accepted, would not result in any modification of the judgment below, a ruling thereon would be purely advisory and beyond this Court's power to issue.

I

The court below properly held to be applicable here the Tenth Circuit's holding in *Cities Service*, 337 F. 2d 97, that the comparable Commission order there involved violated the "rate-principle of separating regulated and unregulated profits and losses." In light of the Commission's limited statutory jurisdiction, the Commission and the courts have repeatedly affirmed that the costs and expenses associated with activities not subject to Commission regulation must be excluded from any determination of rates for sales subject to the Commission's jurisdiction; "otherwise the profits or losses * * * of the unregulated company would be assigned to the regulated business and the Commission

would transgress the jurisdictional lines which Congress wrote into the act." *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 324 U.S. 635, 641-642 (1945).

United's jurisdictional customers have not supplied any of the capital for the non-jurisdictional oil operations of Union and Overseas. Nor could they be—nor have they been—called upon to bear any of the expenses, risks, or losses of these non-jurisdictional activities. Indeed, the rates charged to United's jurisdictional customers are no higher by virtue of United's joining in a consolidated return with Union than they would have been if United were an independent company and filed a separate return. Accordingly, the Act's prohibition against allocating non-jurisdictional profits or losses to jurisdictional operations also bars appropriation of any part of the tax benefits of these non-jurisdictional losses for the jurisdictional customers. Under the Commission's contrary argument, the jurisdictional rates would fluctuate with the success or degree of failure of non-jurisdictional activities; the greater the losses from non-jurisdictional operations, the lower the jurisdictional rates—and vice versa—even though every element of the jurisdictional cost of service remained unchanged.

II

A. Petitioners' claim, that a sharing of the benefits of the non-jurisdictional tax losses is proper because United's taxable income was necessary to the realization of these benefits, has no foundation in fact even assuming, *arguendo*, that such arguments may be considered at this time. First, contrary to Petitioners' arguments, the unchallenged evidence in the record shows that Union could itself have generated enough

taxable income to realize the full benefits of its tax losses under the carry-back and carry-forward provisions of Section 172 of the Internal Revenue Code.

Second, while Petitioners' arguments would treat United as entirely regulated, the Commission admits that only 44% of United's sales are subject to its jurisdiction. If United's taxable income were divided into its jurisdictional and non-jurisdictional segments, United's non-jurisdictional taxable income alone would be more than adequate to realize the full benefits of Union's non-jurisdictional tax losses. In addition, the Commission improperly treated the Gas Corporation as regulated; in fact, it is not regulated at all by the Commission and its taxable income over the critical period was nearly 3 times Union's tax losses. Thus, United's jurisdictional taxable income plainly is not needed to realize the full benefits of Union's tax losses, particularly since the Commission itself recognized (Br., p. 7) that "* * * any losses sustained by an unregulated company or activity must first be set off against the total income of *all unregulated operations.*"

Third, United's rate payers are not underwriters or guarantors of, and/or partners in, Union's non-jurisdictional oil business. Not only are United's jurisdictional rates fixed at a level no higher than necessary to recoup the jurisdictional cost of service (including a non-confiscatory return), but the jurisdictional customers have no liability to creditors of United or Union should either of them become delinquent and fail to pay expenses or costs incurred by them. Rather, the only obligation of jurisdictional customers is to pay for the gas delivered to them as in any other conventional sale of a service or a commodity. And, as in a conventional

sale, once United's jurisdictional customers pay for their gas, they have no interest either in the monies thus paid over or in what United's stockholders decide further to do with these monies.

Fourth, United's ratepayers do not bear any higher costs of capital attributable to Union's allegedly riskier exploration and development operations. The Gas Corporation's cost of capital—which the Commission used in determining United's rate of return—is *lower* than United's separate cost of capital, rather than higher as implied by Memphis. Moreover, the alleged high profitability of Union's production activities may very well have been an important factor in keeping down the Gas Corporation's cost of capital. Indeed, it appears that Union has contributed more than it has received as far as United's jurisdictional customers are concerned.

B. Aside from the factual infirmities in Petitioners' arguments, there are several legal obstacles to their proposed appropriation of a part of Union's non-jurisdictional tax losses for United's jurisdictional rates: First, by depriving the United group of all or part of the benefits of these tax losses, such appropriation would frustrate the purposes of the offset provisions of the tax laws to stimulate investments by mitigating the impact of loss operations. That purpose is apparent not only from the legislative history of these provisions, but also from the fact that under these provisions the *government* shares a company's losses with its stockholders and hence they operate to reduce a minus (loss), not to add a plus (profit).

Second, such appropriation would improperly impair the ability of regulated companies effectively to compete in non-jurisdictional activities. The effect

of depriving a regulated company of the benefits of non-jurisdictional tax losses would place them at a disadvantage vis-a-vis their unregulated competitors who would be able to retain the full benefits of their tax losses. As a result, regulated companies would be deterred from undertaking non-jurisdictional ventures and unregulated companies would be discouraged from undertaking or acquiring regulated businesses.

Third, such appropriation would adversely affect the Gas Corporation's stockholders. The tax regulations (Sections 1.1502-34 and 1.1502-35) provide for a reduction in a parent company's tax basis on its investment in a subsidiary by the amount of the loss utilized through a consolidated return. Hence, should the Gas Corporation sell or abandon the non-jurisdictional operations of Union, it would be deprived of the benefits of the tax losses previously offset through the use of consolidated returns even though the actual benefits thereof had been passed on to United's jurisdictional customers.

Finally, such appropriation would conflict with the oil exploration and development incentives provided by Congress. The effect of passing on to United's jurisdictional customers all or even part of the benefits of the tax losses resulting from the use of these incentives, is to put to naught the Congressional purposes underlying the tax provisions which make possible these tax losses.

III

Contrary to the arguments of the Commission and Memphis, the applicable precedents support the result below, rather than that urged by them. None of the several Commission cases upon which they rely in-

volved the question here presented; rather, they related to the determination of an equitable allocation of tax deductions, particularly interest expenses, incurred by a parent on behalf of its subsidiaries. Hence, the real problem in those cases was that of allocating to jurisdictional operations the full costs associated therewith.

On the other hand, the case which the Commission would now classify as an exception, *Olin Gas Transmission Corp.*, 17 F.P.C. 685 (1956), is the only prior Commission decision specifically dealing with the present issue. There the Commission specifically recognized the impropriety of appropriating tax losses of non-jurisdictional activities to reduce jurisdictional rates. This result is supported by the decision of various State courts and regulatory commissions which have had occasion to consider the problem.

ARGUMENT

INTRODUCTION

One might get the impression from reading the briefs of the Commission and Memphis that the tax losses of Union and Overseas which the Commission utilized to reduce United's income tax allowances were in effect incurred by United and pertained to related jurisdictional, *i.e.* gas, production activities, and hence that the issue here concerned the propriety of the Commission utilizing such related jurisdictional tax losses to reduce the income tax allowed in United's jurisdictional cost of service. For example, the Commission's Summary of Argument (Br., p. 9) describes the holding below without even a reference to separate unrelated and non-jurisdictional oil operations of Union and Overseas, *i.e.*, as involving a situation

"where an *integrated gas* utility system files consolidated Federal income tax returns, in which the tax losses of the *producing* affiliates are offset against the taxable income of the transmission and distributing members * * *." See, also, the Commission's Brief at pp. 10, 21, 22, 23; Memphis Brief at pp. 11, 12, 17-20, 28.

The fact is, however, that tax losses arising from related jurisdictional gas operations are not involved in, nor are a part of, the question which the Commission and the court below undertook to decide in the opinions here under review. In short, there is no issue here presented with regard to related jurisdictional tax losses of Union. To the contrary, the issue presented relates to the propriety of using the tax losses resulting from *unrelated* and *non-jurisdictional* oil operations of Union and Overseas,[4] corporate entities separate and distinct from United, to reduce the income taxes allowed in United's cost of service for the benefit of its jurisdictional gas customers.[5]

In this regard, it is noteworthy that contrary to the Commission's assertion (Br., p. 21) that the record does not disclose the extent of the tax losses attributable to Union's oil operations, the Commission in

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[4] Although Overseas' non-jurisdictional losses were comparatively small, they illustrate graphically the problem and principle here involved.

[5] See, *e.g.*, the Stipulation of Commission Staff counsel at the hearings (I.R. 120):

> "The consolidated tax technique will give to the benefit of United Gas Pipe Line customers * * * an effective tax rate lower than 52 per cent, and * * * this results from the taking into account Union's losses on oil as well as Union's losses on gas."

its opinion expressly recognized that "* * * the record would permit an allocation of Union's taxable income between its regulated and non-regulated business" (II R. 42). Such an allocation is set out in Appendix D to United's brief which shows that the net *tax losses,* incurred by Union over the five-year period (1957-1961) utilized by the Commission, are in fact wholly attributable to Union's *oil* operations, *with its gas operations having a net taxable income over that period.*

It also is important to emphasize at the outset that the Commission is not here quarreling with the *judgment* of the court below setting aside the Commission's order herein. The Commission itself recognizes that it went too far in utilizing *all* the benefits of Union's and Overseas' non-jurisdictional tax losses to reduce the taxable income of the so-called regulated companies in the United Group. Not only does the Commission state in its Petition for Certiorari (at p. 10, fn. 8):

> "There may indeed be problems in the application of the particular formula used by the Commission in this case, a formula which may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group,"[6]

but it explicitly recognizes in its brief on the merits that such, indeed, is the result reached in the Commission's opinion here under review. Thus, it expressly notes

[6] It bears noting that the use of the formula would result in appropriating *all* of "tax saving" not used up against non-jurisdictional taxable income, for "regulated members of the consolidated group" *in all cases,* not just "in this case." Thus, contrary to the Commission's argument (Br., p. 15), the Commission's approach in its opinion here under review in fact no more involves allocation than does the ruling below.

(at p. 15) that "the particular formula utilized by the Commission * * * as applied to the facts of this case, results in allocating the whole of the savings to the companies that had taxable income" *i.e.* to the "regulated members of the consolidated group."

Despite this recognition of basic error in the Commission's order here under review, the Commission now asks (at p. 28) for reversal of the judgment below (see, also, Memphis Br., p. 29) and attempts to support such relief by urging error on the part of the court below because it failed to recognize an alleged propriety of a *sharing* of the benefits of the non-jurisdictional tax losses.[7]

But the effect of granting the reversal urged by the Commission would be to reinstate the Commission's order which the Commission now admits is erroneous. Moreover, this sharing theory played no part in the Commission decision herein. Nor was it urged upon the court below. Instead, the Commission and Memphis there sought affirmance of the Commission's appropriation of *all* the benefits of the non-jurisdictional tax losses for the so-called regulated companies in the United Group.

It is well established that judicial review of administrative action is far narrower than review of trial court decisions in that the courts may judge an administrative order only upon the grounds on which the agency based its action "for purposes of affirming no

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[7] It is interesting to observe, however, that while the Commission and Memphis now press a "sharing" concept, neither suggest what would be a "fair" sharing of the benefits of the non-jurisdictional tax losses.

less than reversing its orders," *S.E.C.* v. *Chenery Corp.*, 318 U.S. 80, 87, 88 (1943); see, also, *e.g.*, *Texas Gas Transmission Co.* v. *Shell Oil Co.*, 363 U.S. 263, 270 (1960); *American Trucking Ass'ns, Inc.* v. *United States*, 364 U.S. 1, 14 (1960). In these circumstances, we submit, the court below did not commit error in not dealing with the new approach now being advanced by the Commission and Memphis—particularly since the use of such approach would, in any event, be improper, and, even if adopted, would not alter the judgment of the court below.

Indeed, since the new approach now being urged by the Commission and Memphis would not affect the judgment entered by the court below, it would appear that what they seek from this Court is "a useless and profitless reversal" in the form of an advisory opinion, which this Court has traditionally held that it has no jurisdiction to issue. *Flournoy* v. *Wiener*, 321 U.S. 253, 262 (1944) and cases there cited; *Lederer* v. *McGarvey*, 271 U.S. 342, 344 (1926); *Aetna Life Insurance Co.* v. *Haworth*, 300 U.S. 227, 240-241 (1937) and cases there cited. In any case, as we will now show, not only is the substantive ground on which the court below based its decision eminently sound, but the new rationale of the Commission and Memphis has no foundation either in fact or in law.

I

The Commission's Utilization of Union's and Overseas's Non-Jurisdictional and Unrelated Tax Losses To Determine United's Tax Allowance Transgresses the Limitation Upon the Commission's Jurisdiction

In setting aside the Commission's order here under review, the court below ruled that the Commission acted "contrary to the requirements which Congress has imposed" (II R. 72) by reducing United's income tax allowance because another of the "affiliated companies which is not subject to Federal Power Commission jurisdiction, sustained losses" (II R. 21). As already noted earlier, the court below thereby agreed with the decision of the Court of Appeals for the Tenth Circuit in *Cities Service Gas Co.* v. *F.P.C.*, 337 F. 2d 97 (1963), and expressly noted "that the principles which are announced in [the *Cities Service*] opinion are here applicable and controlling" (II R. 72).

In the *Cities Service* decision, thus approved and followed by the court below, the relevant facts closely paralleled those which the Commission understood were presented in this case. Indeed, the Commission's opinion here undertakes to apply the formula used in *Cities Service* in determining the so-called "effective consolidated tax rate" for United. In the *Cities Service* case, the Commission had similarly undertaken to appropriate the net tax losses of domestic and foreign non-jurisdictional and unrelated affiliates to reduce the income tax allowance included in the cost of service for jurisdictional operations. 30 F.P.C. 158. The Tenth Circuit reversed, holding that the Commission's action violated the well-established "rate-principle of separating regulated and nonregulated profits and losses" (337 F. 2d at 99). Further noting that the

Commission had been careful to comply with this principle in other respects (*Id.* at 98-99),[8] the Tenth Circuit ruled (*Id.* at 100-101):

> "We know, of course, that the Commission is free to choose most any method which it deems appropriate in the determination of just and reasonable rates for jurisdictional gas sales—usually a legitimate end justifies the means. [citations omitted] But, we know equally well that the method utilized must surely be within acknowledged jurisdictional limits which require an effective separation of regulated and nonregulated activities for the determination of the ingredients of the rate base. As applied to our case, it means a separation of profits and losses between regulated and nonregulated businesses in determining the tax allowance includible in the cost of service of the regulated company. * * *"

Basic to the disposition of this proceeding, as well as to *Cities Service,* is the fundamental rate-making principle, which, as the Commission recognized in *Cities Service* (30 F.P.C. at 162), requires "a separation between regulated and unregulated costs and revenues." For when the true thrust and scope of this principle is fully brought to bear, it becomes clear not only that this principle has been violated by the Commission in this proceeding, as in *Cities Service,* but

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[8] The Commission's *Cities Service* opinion expressly recognizes that "the fundamental ratemaking principle governing our disposition of this issue requires a separation between regulated and unregulated costs and revenues" (30 F.P.C. at 162), and acknowledges that "This principle controls our allocation of other costs which are jointly incurred by regulated and unregulated companies or departments within the same company, and is controlling here" (*Ibid.*).

that as a result of that violation, the Commission has exceeded its jurisdiction under the Natural Gas Act.

It is, of course, a truism that the Federal Power Commission, as an agency created by Congress, has only such jurisdiction as is bestowed upon it by Congress. For the present purposes, the only statute pertinent, so far as the Commission's jurisdiction is concerned, is the Natural Gas Act. Examination of that Act leaves no doubt that the Commission's authority thereunder extends only to regulation of the natural gas business. Section 1(b) of the Act expressly states:

> "The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, * * *."

Even this authority does not extend to all facets or segments of that business. Thus, Section 1(b) goes on to provide that the Act's provisions:

> "* * * shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas" (see, also, Section 1(c)).

Manifestly the Commission's limited jurisdiction over natural gas does not extend to domestic and overseas oil operations, which generated the tax losses involved in this case.

In view of the above express statutory limitations, pipeline rate proceedings before the Commission—which are based on the cost of service concept—have

long proceeded on the premises (1) that the rates fixed for sales subject to the Commission's jurisdiction should be based solely upon income and expenses incurred in connection with such sales; and (2) that where the pipeline company involved also is engaged in non-jurisdictional sales or activities, the income and expenses associated therewith must be separated out in order to assure that the Commission keeps within its jurisdictional bounds. See, *e.g.*, *Mississippi River Fuel Corp.*, 4 F.P.C. 340, 351, 355-6, *aff'd in part, Mississippi River Fuel Corp.* v. *F.P.C.*, 163 F. 2d 433 (D.C. Cir., 1947); *Interstate Natural Gas Co.*, 3 F.P.C. 416, 428 (1943), *aff'd, Interstate Natural Gas Co.* v. *F.P.C.*, 156 F. 2d 949 (5th Cir., 1946), *aff'd*, 331 U.S. 682 (1947), *Cities Service Gas Co.*, 3 F.P.C. 459, 485 (1943). For example, in the *Mississippi River Fuel* case, the Commission stated (4 F.P.C. at 351):

> "* * * Mississippi has then two classes of customers—utility and industrial. The rates for gas sold directly to industrial customers are not subject to our jurisdiction, so it is necessary to make an allocation of costs of service to segregate the regulated and unregulated business."

Since the Commission has in the past consistently abided by these jurisdictional limitations, there has been a paucity of cases in which the courts have had to deal with claims that the Commission exceeded its jurisdiction by taking into account non-jurisdictional income and expenses in determining jurisdictional rates. However, in the few cases in which such an issue has been raised, the courts have affirmed the principle that the rates fixed by the Commission for sales subject to its jurisdiction must be based solely upon the costs and expenses associated with these sales.

Colorado Interstate Gas Co. v. *F.P.C.*, 324 U.S. 581 (1945); *Panhandle Eastern Pipe Line* v. *F.P.C.*, 324 U.S. 635 (1945); *Mississippi River Fuel Corp.* v. *F.P.C.*, 163 F. 2d 433, 437 (D.C. Cir., 1947); cf. *Smith* v. *Illinois Bell Telephone Co.*, 282 U.S. 133 (1930). In the *Colorado Interstate* case, where the company claimed, *inter alia*, that the Commission had improperly taken non-jurisdictional operations into consideration in fixing jurisdictional rates, this Court stated (324 U.S. at 593-4):

> "* * * The Commission included in the total cost of service for these companies a 6½ percent return on the rate base (Fn. omitted). In other words, the 6½ percent return was computed on the basis of all the property used by petitioners in their various classes of business—intrastate sales, direct industrial sales, and interstate wholesale sales. (Fn. omitted). Now it is apparent *that if the reduction ordered was based on the excess of revenues from all classes of business over the aggregate costs, the result would be to reduce to a common level the profits from each class. In that case, whenever a company was making a higher return on its unregulated business than the rate of return allowed for the regulated business, the excess earnings from the unregulated part would be appropriated to the entire business.* When the unregulated business was being operated at a loss or at less than the return which was allowed, excess earnings from the regulated business would be appropriated to the unregulated business * * *.
>
> "* * * It is said that that is what happened here. But that is not true. *As we have seen, the Commission ordered a rate reduction based solely on the excess of revenues over costs (including return) derived from the regulated business. None of the excess revenues over costs (including return) from the unregulated business was included in that reduction.*"

And in the *Panhandle Eastern* case, where the question again was raised in the context of the Commission's alleged failure to allocate the Company's properties and costs between jurisdictional and non-jurisdictional business, this Court similarly commented (324 U.S. at 641-2):

> "We agree that the Commission must make a separation of the regulated and unregulated business when it fixes the interstate wholesale rates of a company whose activities embrace both. *Otherwise, the profits or losses, as the case may be, of the unregulated company would be assigned to the regulated business and the Commission would transgress the jurisdictional lines* which Congress wrote into the Act."[9]

The same reasoning, we submit, requires that the limitations on the Commission's jurisdiction be respected so as not to transfer to United's jurisdictional customers the tax benefits flowing from the unrelated and non-jurisdictional (oil) tax losses of Union and Overseas. As shown below, the jurisdictional customers of United did not supply any of the capital used for investment in those operations of Union and Overseas in connection with which these tax losses were incurred. Nor could United's jurisdictional customers be—nor have they been—called upon to bear any part of the expenses, risks or losses which might be incurred in connection with those operations. To the contrary, the Commission has gone to great pains to

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[9] Although the *Colorado Interstate* and *Panhandle Eastern* cases involved jurisdictional and non-jurisdictional activities of a single corporate entity, the principle is, as the Commission recognized in *Cities Service* (30 F.P.C. at 162), fully applicable to jurisdictional and non-jurisdictional activities of corporate affiliates.

assure that its determination of the cost of service for United's business subject to Commission jurisdiction include only those costs incurred in connection therewith.

In other words, the revenues and expenses of United's jurisdictional business have scrupulously been kept separate and distinct from all non-jurisdictional business of the United group, including the unrelated and non-jurisdictional business of Union and Overseas, and hence do not have any tie with, or relationship to, the tax losses attributable to the non-jurisdictional oil business of Union and Overseas. See II R. 54. Thus, United's joining in a consolidated return with Union and Overseas did not operate to increase the rates charged to United's jurisdictional customers over what they would have been if United were not affiliated with Union and Overseas and had filed its own separate return.

In these circumstances, since the Natural Gas Act precludes the Commission from allocating any part of the profits or losses of non-jurisdictional activities to jurisdictional operations, the Act *a fortiori* bars the Commission from transferring the tax benefits of such non-jurisdictional losses to the jurisdictional customers. Significant in this regard is the Commission's express acknowledgment in *Cities Service,* 30 F.P.C. at 162 that:

> "* * * If we were to allocate the consolidated system tax return among all profit companies including those in whole or part engaged in unregulated activities, there would be no sound reason for refusing to fix jurisdictional rates at a level sufficient to make up any real losses these companies might suffer."

By the same token, the converse is equally true. Since the statute precludes the fixing of the jurisdictional rates at a level sufficient to make up the losses, tax or otherwise, of the non-jurisdictional activities, there is no basis in the statute—or in logic or equity—to allocate to the jurisdictional activities the benefits of non-jurisdictional tax losses.

The impropriety of the Commission's approach is emphasized by the fact that it leads to highly incongruous results. Every time the amount of non-jurisdictional tax losses changes, the consolidated effective tax rate would similarly change. This would be accentuated where, as here, a major non-jurisdictional activity is oil exploration and development, since that business is typified by wide swings in earnings and tax losses. Moreover, under the Commission's approach, the tax allowable to United *bears no relationship whatsoever to the taxable income generated by United's jurisdictional business,* and the level of United's rates would depend upon the success or degree of failure of the non-jurisdictional activities of Union and Overseas —the greater the losses from non-jurisdictional operations, the lower would be United's jurisdictional rates. Similarly, the less the losses from non-jurisdictional operations, the higher would be United's jurisdictional rates. *And this would be so even though every element of United's jurisdictional cost of service remains unchanged.* The very fact that natural gas rates subject to the Commission's jurisdiction would go up or down, depending on the profitability or degree of non-profitability of non-jurisdictional operations of affiliates, is proof-positive of the illegality and impropriety of the Commission's action here involved.

II.

The Inclusion of United in Consolidated Returns Does Not Justify Allocating to It Any Part of the Benefits of the Unrelated and Non-Jurisdictional Tax Losses of Union and Overseas

Ignoring the jurisdictional ground on which the court below set aside the Commission's order herein and, indeed, as already noted, conceding that the Commission had in fact erred in utilizing the full amount of Union's and Overseas' tax losses as an offset against the taxable income of the so-called "regulated" companies, the Commission now argues that the court below erred in failing to recognize that a *sharing* of the benefits of the tax losses could properly have been required.[10] Thus, claiming (Br., p. 16) that the taxable income of the "regulated companies" was "indispensable to the realization of tax savings from the tax losses of the producing companies," the Commission now asserts (Br., pp. 16-17):

> "Without tax losses to set off against taxable income, there would, of course, have been no tax benefit to be obtained by filing consolidated returns. Equally, however, without taxable income the tax losses could not have been translated into tax savings. If United and Gas Corporation had not had any taxable income, the group would not

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[10] As pointed out earlier herein, the Commission neither based its decision herein on the theory of sharing the benefits of the net tax losses, nor did it urge any such result upon the court below. Rather, the entire thrust of its argument to the court below was in support of the result which the Commission now admits to be erroneous. Consequently, the several arguments advanced by the Commission and Memphis in support of such sharing suffer from the basic infirmity that well settled principles preclude their consideration in support of the Commission's action here. *E.g. S.E.C.* v. *Chenery Corp.*, 318 U.S. 80, 88 (1943).

> have received, as it did, the equivalent of a $2 million rebate as a result of the producing member's losses. And since the income was very largely contributed by United ratepayers [fn. omitted] we submit that they are entitled to share in the resulting tax benefit."

These arguments have no foundation either in fact or law.

A. The Taxable Income of United's Jurisdictional Business Was Not Needed to Realize the Benefits of the Non-Jurisdictional Tax Losses

The assumption, underlying the Commission's present argument for a sharing of the benefits of the non-jurisdictional tax losses, namely, that the taxable income of United's jurisdictional business was necessary to realize the benefits of these non-jurisdictional tax losses, is, as shown below, without support or justification in the record and, indeed, is contrary to the evidence therein. In addition, as also shown below, the non-jurisdictional operations of the consolidated group are "in nowise supported by the pipeline operations" (*Cf.* Comm. Br., p. 15). Consequently, the two conditions which the Commission claims is necessary to give "cogency" to the holding below (Br., p. 15),[11] are, in fact, present in this case.

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[11] As stated by the Commission (Br., p. 15), the holding below "might have considerable cogency if the tax savings were indeed wholly attributable to the non-pipeline operations of the consolidated group, and if, in addition, those operations were in nowise supported by the pipeline operations. * * *"

1. Union Would Have Realized the Full Benefits of Its Tax Losses Without the Taxable Income of United's Jurisdictional Business

While it is true, of course, that tax losses may go to waste in the absence of offsetting taxable income, the record here is clear that Union could itself have generated enough taxable income to realize the full benefits of its tax losses under carry-back and carry-forward provisions of Section 172 of the Internal Revenue Code,[12] and hence that none of United's jurisdictional taxable income was in fact needed to realize the benefits of Union's tax losses.[13] Thus, United's witness Dunn expressly testified that a study made by him " * * * proves conclusively that whether a consolidated return basis is used or a separate return basis is used, Union, itself, can use all of its tax reductions. Therefore, there is no tax loss that is ever of any use to the other two companies" (I.R. 71-72). Significantly, no one challenged this testimony.

In contrast to the complete absence of controversy on this matter *at the hearing*, the Commission would now argue to this Court that the provisions of Section 172 are irrelevant because (Comm. Br., p. 18; see also Memphis Br., pp. 13-14, 22-23):

> "These provisions depend upon the loss corporation's having taxable income within prescribed time periods sufficient to absorb the losses and there is no indication that these are likely contingencies for the producing members of the United system [fn. omitted]."

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[12] Section 172 provides that tax losses may be carried back three years and carried forward for five years. This makes a total of nine years, including the year in which the tax return is filed, in which losses can be offset against income.

[13] The argument in the text is made in terms of Union's non-jurisdictional tax losses for simplicity.

However, as testified to by Mr. Dunn (I.R. 100):

> "* * * Union being a producing company, its tax deductions are controllable. Union can control how many wells it drills in any year, and one of the main items of tax deduction is well drilling expense, both producing wells and non-producing wells, and in any given period of time Union can control to a very large extent how many wells it drills, so that there is no reason whatever to assume that Union Producing Company, being a highly successful production company and with large gas and oil reserves, proven oil reserves, would ever be in a position of not being able to utilize its tax deductions."

2. The Non-Jurisdictional Taxable Income of the United Group Is Ample To Realize the Full Benefits of Union's Non-Jurisdictional Tax Losses

Quite apart from the carry-back and carry-forward provisions of Section 172, it is clear that the taxable income attributable to United's *jurisdictional* business is not needed to obtain the benefits of Union's and Overseas' non-jurisdictional tax losses. Significantly, no finding or argument to the contrary has even been made either in the Commission's opinion or in the briefs filed herein by the Commission and Memphis. Instead, the Commission reached the result it did by treating United as if it were regulated by the Commission *in its entirety* although the record shows (II R. 54), and the Commission now recognizes (Br., p. 3), that *only 44 percent* of United's sales of natural gas are subject to Commission regulation.[14]

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[14] The same group of exhibits on which this Commission statement is based shows that of the 56% of United's sales not subject to Commission regulation, about 9% is subject to state regulation as so-called town border sales and the remaining 47% are direct sales not subject to any regulation.

The Commission obviously has no more authority or power with regard to 56 percent of United's sales—which, the Commission implicitly admits, is not subject to its jurisdiction—than it has with regard, for example, to the oil production activities of Union and Overseas. Indeed, as mentioned earlier, the Commission has gone out of its way to adhere in all other respects to a strict segregation of revenues and costs between United's jurisdictional business, on the one hand, and its non-jurisdictional business, on the other. Consequently, there is no reason or justification for the Commission to treat as regulated the non-jurisdictional portion of United's business in determining the income tax allowance to be included in United's jurisdictional cost of service.

Had the Commission allocated United's total taxable income as shown for each year in Exhibit 36 (Revised) (II R. 24) between United's jurisdictional (44%) and non-jurisdictional sales (56%), it would have found that United *alone* had more than enough *non-jurisdictional taxable income* in each year of the period 1957-61 (here used) to offset all of Union's non-jurisdictional tax losses and thereby realize the full benefits of these tax losses. Hence, when United's operations are properly classified in accordance with the limitations upon the Commission's jurisdiction, it is plain that in not one of the five years used by the Commission was United's jurisdictional taxable income in fact needed to realize any part of the benefits of the non-jurisdictional oil tax losses.

That there is no need for United's jurisdictional taxable income to realize the benefits of the non-jurisdictional tax losses can be further seen from the fact that the same Exhibit 36 (Revised) also shows that the

Gas Corporation's taxable income—all of which is non-jurisdictional as far as the Commission is concerned—is nearly three times as great as Union's net taxable losses over the 1957-61 period.

The foregoing also answers the Commission's further claim (Br., pp. 17-18; see also Memphis Br., pp. 23-27) that it is improper:

> "to say that United did not contribute to the tax savings because Gas Corporation's taxable income was sufficient in itself to cover the producing companies' losses and so enable the savings to be realized. It is completely arbitrary to regard Gas Corporation as having made the decisive contribution."

At the foundation of this argument is the assumption that the Commission properly treated United's non-jurisdictional activities and the Gas Corporation as regulated for the purpose of determining the income tax allowance to be included in United's jurisdictional cost of service. When the invalidity of this assumption is recognized, it becomes apparent, as shown earlier, that any effort to invoke United's jurisdictional taxable income as needed to realize the benefits of the System's non-jurisdictional tax losses, would be inconsistent both with the Commission's procedure here involved whereby "* * * any losses sustained by an unregulated company or activity must first be set off against the total income of *all* unregulated operations" (Comm. Br., p. 7) and with its express recognition in *Cities Service*, 30 F.P.C. at 162, that:

> "If we were to allocate the consolidated system tax return among all profit companies, *including those in whole or part engaged in unregulated activities*, there would be no sound reason for re-

fusing to fix jurisdictional rates at a level sufficient to make up any real losses these companies might suffer."

3. United's Jurisdictional Rate Payers Are Not Underwriters of, or Guarantors or Partners in, the United Group's Non-Jurisdictional Oil Business

The Commission further attempts to support its claim that United's jurisdictional rate payers may properly share in the benefits of the non-jurisdictional tax losses of the United Group by urging that "the rate payers [presumably of United's jurisdictional business] are * * * in effect underwriters of the investors' ventures" (Br., p. 21), and that "United's ratepayers were in effect partners of the system's investors in the gas and oil operations that gave rise to the tax losses and the resulting tax benefit." (Br., p. 22). This argument assumes as a fact that the jurisdictional pipeline activities support the non-jurisdictional production activities. It can as readily, and, we suggest, more readily be assumed that the converse is true, and that Union's non-jurisdictional activities contributes at least its full share to the corporate well-being of the United system. In any event, the record is void on this factual question, and, as indicated earlier, the argument is made for the first time in this Court in an effort to support the present position of the Commission.[15]

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[15] The Commission's brief also repeatedly mislabels gas pipelines as "public utilities," and even on one occasion refers to them as "franchised monopolies" (Br., p. 17). Gas pipelines have no franchised monopolies, and, accordingly are not public utilities in the sense commonly employed. Gas pipelines have no protected service areas, they have no statutory obligation to enlarge their facilities, and they are not common carriers (See Section 7(a) of the Act)

First, contrary to the Commission's repeated assertions on which these arguments are largely based, the "'profitability" of United's jurisdictional business is not "virtually guaranteed" (Br., p. 17), nor is there any assurance of a "steady stream of substantial profits" from such jurisdictional business (Br., p. 20), nor any obligation upon "United's ratepayers * * * to pay rates high enough to ensure a fair return to the pipeline's investors" (Br., p. 21). The fact is, as this Court has frequently admonished, that "regulation does not assure that the business shall produce net revenues." *F.P.C.* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 590 (1942); *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Market Street Ry. Co.* v. *California Railroad Commission*, 324 U.S. 548, 566 (1945).

Second, even if there were an assurance of a steady stream of substantial profits with regard to United's jurisdictional business, it would not serve to make United's ratepayers in effect "underwriters" or "partners" in the non-jurisdictional activities of the United Group.[16] The rates paid by United's jurisdictional customers are fixed at a level no higher than necessary to enable United—if it actually makes jurisdictional sales at the level estimated at the time the rates are fixed—to recoup the cost of service (including a non-confiscatory return) *incurred in connection with its jurisdictional activities.* In other words, United's jurisdictional rates are determined without regard to the

[16] The Commission's suggestion that United provides an assured market for Union's *gas* production (Br., p. 21) is wholly beside the point since this case is concerned with tax losses from oil production. In any case, since there is no control over the location of gas reserves, gas found by Union may or may not be within economic distance from United's lines.

profits earned or losses incurred in connection with the United group's non-jurisdictional activities.

Indeed, as pointed out earlier, the Commission had always been careful to exclude all of the costs or expenses incurred in connection with non-jurisdictional activities from the jurisdictional cost of service. Thus, jurisdictional costs are determined as if the jurisdictional portion of United's business stood alone as a separate entity wholly distinct from the group's non-jurisdictional activities and the rates fixed for such jurisdictional business are unaffected by the success, or lack of success, of the group's non-jurisdictional activities.

In addition, the jurisdictional customers are under no liability to pay United's creditors for any of the costs or expenses incurred by United in connection with its jurisdictional business, should United become delinquent and fail to pay these obligations—even though they were incurred for the benefit of those customers. Much less would United's jurisdictional ratepayers be under any obligation to pay any of the costs or expenses incurred in connection with United's non-jurisdictional business and even less, those incurred by *Union* in either its jurisdictional gas business or non-jurisdictional oil business. Plainly, therefore, the payments by United's jurisdictional customers to United are nothing more than the traditional consideration paid by a customer for a conventional sale of a service or a commodity and do not involve any underwriting or guarantee obligation on the part of United's jurisdictional customers. *E.g. Board of Public Utility Commissioners* v. *New York Telephone Company,* 271 U.S. 23, 32 (1926); *Smith* v. *Illinois Bell Telephone Co.,* 282 U.S. 133, 158 (1930); *Hope Natural Gas Co.* v. *F.P.C.,* 134 F. 2d 287, 301 (4th

Cir. 1943), reversed on other grounds, 320 U.S. 591 (1944).

As a matter of fact, as in conventional sales, the jurisdictional customers have no concern with, or interest in, the monies which they pay over to United once they have made such payment, and all the "profits" if any, belong entirely to United's investors to do with as they see fit. By the same token, the decision whether to reinvest the "profit" in non-jurisdictional activities and if so, the extent thereof, is made solely by United's management and investors. Such decisions are of no concern to United's jurisdictional customers and they do not participate therein in any way. Patently, United's jurisdictional customers cannot validly be characterized as "partners" in Union's non-jurisdictional activities in any legal or practical sense.

Not only does the Commission itself even now shy away from characterizing United's jurisdictional customers as partners in the sense that they would be "entitled to share in the profits produced by [Union's non-jurisdictional] activities" (Br., p. 22), but the Commission has long since shied away from so regarding United's jurisdictional customers by recognizing in its *Cities Service* opinion, 30 F.P.C. at 162, the impropriety of "fix[ing] jurisdictional rates at a level sufficient to make up any real losses these companies might suffer."

In this regard, it may also be noted that even assuming, as the Commission argues (Br., p. 21), that "oil and gas production are intertwined," there is no substance to its further assertion (*Ibid.*) that "the backing that United's ratepayers supply Union's gas business perforce contributes to Union's oil ventures." For, in addition to the fact just noted, that United's

ratepayers do not supply any backing to Union's gas business, the Commission has always taken great care, including the most recent Union rate proceeding (see *Union Producing Co.*, 31 F.P.C. 41, 48-9, 71-3 (1964)), to separate Union's costs and expenses between its jurisdictional gas business and non-jurisdictional oil business. The "substantial correlation between the group's pipeline operations—supported by United's ratepayers — and its tax-loss production activities" claimed by the Commission (Br., p. 20) simply does not exist.

4. United's Jurisdictional Ratepayers Have Not Borne Any Increased Costs Attributable to Any Allegedly Greater Risks of the Oil Production Business of Union and Overseas

In further support of the propriety of the Commission's utilizing "a fair share of Union's tax losses" to reduce the income taxes allowed in United's cost of service, Memphis argues (Br., p. 21, see also Comm. Br., p. 21):

> "Exploration, development and production operations of Union involve higher degrees of risk and uncertainty than do the pipeline operations of United. This higher degree of risk is reflected in the cost of capital incurred by Corporation in raising capital, and is, in turn, reflected in the rate of return awarded United in light of that cost of capital. Thus, United's consumers bear increased costs of capital directly traceable to Union's riskier operations."

This argument is highly speculative, without any support either in the record or in the Commission's findings, and, indeed, at odds with the relevant available materials.

To be sure, as Memphis states (Br., p. 21) the Commission used the Gas Corporation's cost of capital along with other data it deemed pertinent in fixing United's rate of return. However, it does not follow that, as a result, United's jurisdictional cost of service included a higher cost of capital attributable to any alleged higher risks of Union's production business. The fact is that United's separate cost of capital—without reference to the other companies in the United group—was higher than that of the Gas Corporation. See *United Gas Pipeline Co.*, 25 F.P.C. 26, 110, 114 (1961). Hence, the use of the Gas Corporation's cost of capital, rather than that of United, resulted in a *lower* cost of capital being included in United's cost of service rather than a higher cost, as implied by Memphis.

Also, it should be noted that the rate of return approved by the Commission for Union in the *Union Producing* case utilized the cost of capital to the Gas Corporation *as recommended by Memphis.* See 31 F.P.C. at 74. Similarly, it should be noted that in fixing the rate of return to be included in United's jurisdictional cost of service in the instant proceeding, the Commission expressly pointed out that all parties had stipulated as to the proper rate of return and hence that there was no issue on the matter (See II R. 33). In other words, the Commission did not regard the Gas Corporation's cost of capital as being any the greater because of any greater risks or uncertainties attendant upon the group's production activities, whether jurisdictional or non-jurisdictional. To the contrary, in light of the alleged high profitability of Union's production activities, repeatedly adverted to by the Commission (Br. pp. 6, 11, 22, 23; see also Memphis Br. p. 7), the greater probability is that the Commission regarded these activities as *reducing*

rather than *increasing*, the Gas Corporation's cost of capital.

Finally, even assuming *arguendo* and contrary to the foregoing, that the Gas Corporation's cost of capital were higher than it otherwise would be as a result of Union's production operations, it would not provide any valid justification for utilizing "a fair share of Union's tax losses". (Memphis Br., p. 21) to reduce United's income tax allowance. In the circumstances thus assumed, it would have been incumbent upon the Commission to make findings as to the extent, if any, of such alleged higher cost of capital, and take the fact of such cost into consideration in computing the rate of return for United.[17]

B. The Non-Jurisdictional Tax Losses of Union and Overseas May Not Be Appropriated in Whole or Part To Reduce United's Jurisdictional Rates

Quite apart from whether, as a factual matter, the full benefits of the non-jurisdictional tax losses of Union and Overseas could be realized without the taxable income from United's jurisdictional business, use of all, or even a part, of the group's non-jurisdictional tax losses to reduce the income tax allowance included in United's cost of service and thereby passed on to United's jurisdictional customers, would be legally unsound.

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[17] Memphis' further argument (Br., pp. 14, 24-25) that the income tax allowance for United's jurisdictional business cannot be treated separately because "there is no separate *computation* or *assessment of tax* and no *separate tax liability* for each participant in a consolidated tax return" (emphasis in original) echoes arguments which were made by the Commission Staff in *Cities Service* but which were there expressly rejected by the Commission. See 30 F.P.C. at 160, 162.

1. Appropriation of the Non-Jurisdictional Tax Losses Would Frustrate the Purpose of the Offset Provisions of the Tax Laws

The effect of the provisions of the tax laws permitting the setting off of tax losses against taxable income is that the government waives the tax liability accruing from taxable income to the extent that the taxpayer has tax losses. In other words, the government agrees that it will assume 52 percent (at the then tax rate) of a taxpayer's tax losses to the extent that they can be met from the tax liability accruing from the taxpayer's income.

By providing for such offsets, Congress intended to mitigate the impact of loss operations and thereby to stimulate investments. This may be seen from the history of the tax provisions permitting net operating loss carryover (Int. Rev. Code of 1954, § 172). Thus, after describing the plight of new enterprises and capital goods industries, which are especially subject to wide fluctuations in earnings, the House Ways and Means Committee Report stated (H. Rep. No. 855, 76th Cong., 1st Sess. p. 9 (1939):

> "It is, therefore, believed that the allowance of net operating business loss carry-over will greatly aid business and stimulate new enterprises."

This view was echoed in the remarks on the floor of Congress. Senator Harrison explained (84th Cong. Rec. 7686 (1939):

> "Another important change in the law which was written in the bill as it passed the House and as it had been approved and reported by the Senate committee is the provision permitting corporations to carry over their net operating business losses for a period of 2 years. In my opinion, that is one of the most important provisions in-

corporated in this legislation, and *one which perhaps will give more encouragement to business than any other provision* * * *.'"[18]

The same principle is involved in the consolidated tax return provisions (Int. Rev. Code of 1954, §§ 1501-4) which, instead of offsetting profits and losses lineally over a period of time, offset them horizontally within associated corporate organizations.

The practical effect under both provisions is that the *government* is sharing with the stockholders the losses of a company. Put another way, from a realistic point of view, what is involved is a payment of taxes on certain operations, which is then turned back or forgiven by the government because of the tax losses incurred in connection with other operations. *These tax deductions reduce a minus* (*loss*). *They do not add a plus* (*profit*). And it makes no difference whether the losses are offset through the filing of a consolidated return or utilizing the carry-back and carry-forward provisions of the Code.

In view of the clear purpose of these offset provisions to stimulate investment, it is apparent that the effect of appropriating for United's jurisdictional customers all or even part, of the benefits of the non-jurisdictional tax losses is to deprive the United group of the benefits of the tax losses thus appropriated, and, to that extent, to destroy the incentive which Congress intended by these provisions. In this regard, it cannot be over-emphasized that it is the *government* that is sharing Union's losses, not the customers of the jurisdictional segment of United's business. As al-

[18] As noted earlier, the carry-forward period is now five years and the carry-back period is three years.

ready shown above, the cost of service, on the basis of which United's jurisdictional rates are fixed, does not include any part of the expenses, costs, or losses attributable to Union's and Overseas' non-jurisdictional business. Moreover, inclusion of an income tax allowance in United's jurisdictional cost of service computed on the basis of the full statutory rate would not redound unfavorably against United's jurisdictional customers since they would pay the same rates as they would pay if United had no affiliates engaged in non-jurisdictional operations and had filed a separate return. Thus the jurisdictional customers of United would not be affected unfavorably, in terms of rates by the United group's non-jurisdictional operations. In these circumstances, to deny to the group the benefits which are available to other (nonregulated) companies merely because Union and Overseas were joined in a consolidated return with a company (United) which has operations which are the subject of regulation would frustrate the purposes and objectives involved in permitting tax offsets of losses.

2. The Appropriation of Non-Jurisdictional Tax Losses Would Improperly Impair the Ability of Regulated Companies Effectively To Compete With Non-Jurisdictional Businesses

Requiring that all or part of the benefits of non-jurisdictional tax losses be passed on to jurisdictional ratepayers would impair the ability of regulated companies effectively to compete in non-jurisdictional areas either directly or through affiliates. While a regulated company may be willing to enter upon a new non-jurisdictional venture, knowing that by virtue of the offset provisions in the Internal Revenue Code, the government would bear 52 percent (now 48 percent) of the early losses, it might well be deterred from

embarking upon such new enterprise if it were required to give to, or share with, the customers of its jurisdictional business the benefits of such tax losses. For, in these circumstances, the company engaged in both jurisdictional and non-jurisdictional activities would have to absorb substantially more than 48 cents (now 52 cents) of each dollar of operating tax loss, while its wholly unregulated competitors would be able to offset their tax losses fully against their taxable income and thereby bear only 48 cents (now 52 cents) of each dollar of tax loss. In short, the latter companies would have a distinct competitive advantage over the companies engaged in part, or through affiliates, in regulated activities.

The requirement that a company engaged in both jurisdictional and non-jurisdictional businesses give or share its non-jurisdictional tax losses with the customers of its jurisdictional operations, would, by the same token, also deter companies engaged solely in non-jurisdictional enterprises from undertaking or acquiring ventures which would be subject to the Commission's jurisdiction. Clearly, this would be the logical consequence since they would no longer be permitted to retain the full benefits of their tax losses as they had done prior to entering into jurisdictional operations.[19]

That the diversion of non-jurisdictional tax losses to jurisdictional customers would impair the ability of a company engaged in both jurisdictional and non-juris-

[19] In this regard, it is to be noted that there is no restriction imposed by Congress or any other body or agency upon the nature of the non-jurisdictional (non-utility) activities in which a gas company (or its parent) may engage because of the fact that directly or through affiliates it is engaged in activities subject to regulation by the Commission.

dictional operations to compete with wholly unregulated enterprises may be illustrated by reference to the oil exploration and production business, the primary non-jurisdictional business in which Union is engaged. Union's ability to survive in this highly competitive business obviously would be adversely affected if Union were deprived of any part of the benefits of these tax losses in order to pass them on to United's jurisdictional customers while Union's competitors were able (for a period of nine years) to retain all such tax benefits irrespective of whether their tax returns are filed on an individual company or consolidated return basis. As summarized by the dissenting Commissioners in the *Cities Service* case, 30 F.P.C. at 175:

> "* * * Following the theory of the majority, how can an integrated oil company which also has a natural gas pipeline company within its corporate structure, compete on equal terms with an oil company not having similar pipeline operations, if the latter can use all of its tax savings in the oil business but the former cannot? Clearly, it cannot so compete."

As already shown above, United's ratepayers were not asked to—nor did they provide—any of the money invested in Union's non-jurisdictional activities. Nor do they bear any of the risks, losses or expenses associated therewith. In sum, even without the benefits of these non-jurisdictional tax losses, the rates paid by United's jurisdictional customers are no higher than they would be if United were only a jurisdictional company not affiliated with any company engaged in non-jurisdictional activities. There, accordingly, is simply no basis or justification for utilizing all or even a part of the tax losses resulting from Union's non- ju-

risdictional operations to bestow a wholly gratuitous windfall upon United's jurisdictional customers.

The impropriety of such a result becomes even clearer when viewed from the standpoint of a minority stockholder. An affiliate may be included in a consolidated return filed under Section 1501-1504 of the Internal Revenue Code, so long as the parent corporation owns 80 percent or more of the voting stock of such affiliate. In such circumstances, the minority stockholders of an affiliated company having non-jurisdictional tax losses obviously would want to insist that these tax losses be utilized in a manner which best furthers the interests of that company, and not be appropriated for the jurisdictional customers of an affiliated company, in which the minority stockholders have no interest. But if such tax losses are used to reduce jurisdictional rates, the minority stockholders lose the benefit of the carry-over provisions of the Code, with a concomitant loss of profits which would otherwise proportionately inure to them.

3. The Appropriation of Non-Jurisdictional Tax Losses Would Improperly Deprive the Gas Corporation of Its Property

Under Sections 1.1502-34 and 1.1502-35 of the Income Tax Regulations, where a subsidiary could not have utilized losses under Section 172 of the Internal Revenue Code to reduce its own taxable income for any year, the parent company's tax basis on its investment in that subsidiary is reduced by the amount of the loss utilized through the consolidated return. As a result, should the Gas Corporation sell or abandon the non-jurisdictional operations of Union or Overseas, it would be deprived of the use of the losses which had previously been offset through the use of consolidated

returns. The Gas Corporation, of course, would not be adversely affected if it had benefited fully from utilizing the losses in the consolidated returns to reduce its taxable income. However, should the benefits of any part of those losses be used to reduce United's jurisdictional rates, as the Commission urges be done, the Gas Corporation obviously would be adversely affected. For it would be presumed, under the above Regulations, that the United group had taken advantage of such losses, whereas, in fact, part of those losses would have been appropriated to reduce United's jurisdictional rates.

4. The Appropriation of the Non-Jurisdictional Tax Losses Would Conflict With Oil Exploration and Development Incentives

It is, of course, well known that Congress has allowed special tax benefits for oil exploration and development in the form of percentage depletion and expensing intangible drilling costs. Indeed, the Commission repeatedly claims that Union has in fact had net substantial income and incurred tax losses only because of these special tax provisions (Comm. Br., pp. 6, 11, 22, 23, see also Memphis Br. p. 7). Consequently, since the purpose of these tax provisions is to encourage exploration and development of mineral resources including oil, the effect of appropriating for United's jurisdictional customers all, or even part, of the benefits of these non-jurisdictional tax losses is, to that extent, also to put to naught the Congressional purpose underlying this tax provision.

A recent statement of this Court as to the purpose of percentage depletion is in *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81 (1960):

> "In summary, mineral depletion for tax purposes is an allowance from income for the exhaustion of capital assets. *Anderson* v. *Helvering*, (1940), 310 U.S. 404. In addition, it is based on the belief that its allowance encourages extensive exploration and increasing discoveries of additional minerals to the benefit of the economy and strength of the Nation. * * *"

The Congressional purpose to encourage investment in oil operations is also evident from the legislative history of the deductions for percentage depletion,[20] and for intangible drilling and development costs.[21] As noted in *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F. 2d 567, 571 (5th Cir. 1960), *cert. denied*, 366 U.S. 912 (1961): "It has * * * been recognized not only by Congress but by the courts as well that there is a public interest in the creation of an incentive to cause additional exploration and development in the oil and natural gas industries."

Congress intended the incentive benefits of percentage depletion to apply not only to domestic oil exploration, but also to foreign oil operations like those of Overseas. For, unlike the percentage depletion rate of many minerals, which depends on whether the de-

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[20] The legislative history of depletion allowance is discussed in 4 Mertens, *Law of Federal Income Taxation*, §§ 24.04-24.15b (1960) and in *Legislative History of Depletion Allowances*, Staff of the Joint Comm. on Internal Revenue Taxation, 81st Cong., 2d Sess. (Comm. Print 1950).

[21] For details concerning the legislative history of intangible drilling costs see *e.g.*, Fielder, *The Option to Deduct Intangible Drilling and Development Costs*, 33 Texas L. Rev. 825, 826-30 (1955); Mahin, *Deduction for Intangibles*, Southwestern Legal Foundation, Second Annual Institute on Oil and Gas Law and Taxation 367, 369-78 (1951).

posits are in the United States or elsewhere, the depletion rate for oil remains 27½ percent whether the oil well is located in the United States or elsewhere. See 4 Mertens, Law of Federal Income Taxation, §§ 24.15b; 24.23c. fn. 73.

Memphis (Br., pp. 19-20; see also Comm. Br., pp. 21-25, 27) contends that the *El Paso* case supports its position. But inasmuch as the Fifth Circuit had also decided *El Paso,* its failure even to mention that case in its decision herein strongly indicates that it did not regard its holding in *El Paso* as contrary to its ruling here. There is good reason why this is so. To be sure, the Fifth Circuit in *El Paso* had remanded the Commission's order (22 F.P.C. 260), which had allowed El Paso to retain the tax benefits resulting from the deductions for intangible well drilling expense and percentage depletion. But the fact is that the tax benefits there involved arose solely from tax deductions applicable to El Paso's *natural gas* production business. Indeed, although one might get a broader impression from a casual reading of Memphis' brief, Memphis, in essence, concedes this fact. The key to the limitation upon Memphis' claim is its description of El Paso as a company "engaged in the production, transportation and sale of *natural gas*". Significantly Memphis does not even mention El Paso's non-jurisdictional oil operations.

That the Fifth Circuit's *El Paso* holding does not in fact relate to the tax deductions applicable to the company's oil operations is clear from the court's opinion as well as from the fact that the Commission did not purport to treat with the company's *oil*

production.[22] While the court stated, as quoted by Memphis (Br., p. 21):

> "* * * It is the obligation of all regulated public utilities to operate with all reasonable economies. This applied to tax savings as well as economies of management. The net result of this, of course, is that such savings as are effected are passed on to the consuming public. This we consider to be the natural and necessary consequence of rate regulation,"

the Fifth Circuit plainly could not have intended to hold that El Paso's "public utility" *obligation* required it to operate with all reasonable economies with regard to its non-jurisdictional and unrelated *oil* operations. Moreover, since El Paso's oil activities are not subject to "rate regulation," whatever disposition is made of its "tax savings" resulting from its *oil* operations surely could not be "the natural and necessary consequence of rate regulation." See, also, 30 F.P.C. at 189.

III

The Applicable Precedents Support the Result Below, Rather Than That Urged By Petitioners

Memphis (Br. p. 15, see also p. 9) refers to a number of past Commission decisions as support for its thesis that the Commission's action here

> "adhered to its long-established, administrative practice of including in cost of service an allow-

[22] A comparison of the Commission's *El Paso* opinion with the record in that case clearly reveals that in accordance with the limitations on its jurisdiction discussed earlier in this brief, the Commission excluded from the determination which it there made all items relating to El Paso's *oil* production, such as percentage depletion based on *oil* revenues and the deductions for intangible drilling expense of *oil* wells.

> ance only for taxes actually incurred. Where the company has participated in a consolidated tax return, the Commission has consistently refused to include a hypothetical tax allowance in cost of service based on a separate tax return. The Commission has included in cost of service only a tax allowance at the effective tax rate resulting from participation in the consolidated tax return."

Similarly, but referring to a markedly smaller group of cases, the Commission (Br., p. 14) argues that "with one exception [it] has been consistent in requiring allocation" in circumstances where a regulated company has participated in a consolidated filing. As shown below, these cases are distinguishable and do not support the position of the Commission or of Memphis. As a matter of fact, the cases which do deal with the question here involved are fully in accord with the decision of the court below.

A. The Commission Had Not Previously Contended That It Could Appropriate Non-Jurisdictional Tax Losses to Reduce Jurisdictional Tax Allowances

In relying on the several Commission cases that they do, both the Commission and Memphis gloss over the critical distinction between jurisdictional and non-jurisdictional operations. None of the cases thus referenced by Memphis and the Commission involve the appropriation for the purchasers of gas subject to the Commission's jurisdiction of the benefits of tax losses incurred in unrelated, non-jurisdictional activities. Indeed, in those cases, the Commission neither considered nor discussed whether it could properly use a so-called "consolidated effective tax rate" in circumstances such as those presented here. As summarized by the dis-

senting Commissioners in *Cities Service,* 30 F.P.C. at 171:

> "While the Commission, in the past, has properly insisted that certain tax advantages to be obtained from filing a consolidated return for groups composed entirely, or predominantly, of regulated companies, be passed on to consumers, it has not held that business losses of unregulated and unrelated corporations participating in a consolidated return should be utilized for the benefit of the consumers of a regulated natural gas company. * * *"

Thus, although the Commission's decisions in the cases now relied upon by Memphis and the Commission are cast in terms of reducing the allowable tax below the amount to which the company would have been entitled had it filed a separate return, the real question in those cases generally was that of determining an equitable allocation of tax deductions, particularly interest expenses, incurred by a parent *on behalf* of its subsidiaries. In other words, the real problem was that of allocating to jurisdictional operations the costs *associated therewith.* These problems arose because the parent company in the systems involved in most of the cases had issued debt securities for the financing of its affiliates and "neither respondent nor any other operating gas company * * * has any funded debt outstanding." See *Pub. Util. Comm.* v. *Manufacturers Light & Heat Co.,* 5 P.U.R. 3d 346, 382 (Pa. PUC, 1954) (Columbia System).[23] Accordingly, in such systems, the use of a tax adjustment "is merely the return to the company of that part of the additional

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[23] This was the situation in *Southwestern Bell Tel. Co.* v. *Kansas State Corp. Comm.,* 192 Kan. 39, 386 P. 2d 515, cited by the Commission in its Brief (p. 22, fn. 23).

expense imposed upon it by the method of financing chosen by its parent. * * *" See *Re Chesapeake & Potomac Teleph. Co.*, 6 P.U.R. 3d 222, 244 (D.C. PUC 1954).

Inappropriate for this reason are the references by the Commission and Memphis to the Commission's decisions involving affiliates of the Consolidated Natural Gas System and of the Columbia Gas System, in both of which systems the parents provide the financing for the subsidiaries. *Hope Natural Gas Co.*, 10 F.P.C. 583, 612 (1950), *aff'd as modified*, 10 F.P.C. 625 (1951); *Hope Natural Gas Co.*, 12 F.P.C. 342, 347 (1953); *Atlantic Seaboard Corp.*, 11 F.P.C. 486, 514-15 (1951), *aff'd as modified*, 11 F.P.C. 43 (1952), *remanded on other grounds*, 200 F. 2d 108 (4th Cir., 1952); *United Fuel Gas Co.*, 12 F.P.C. 251, 264-5 (1953); *Home Gas Co.*, 13 F.P.C. 241 (1954); *United Fuel Gas Co.*, 23 F.P.C. 127, 135, n. 15 (1960), *modified in other respects*, 23 F.P.C. 512 (1960).[24]

Penn-York Natural Gas Corp., 5 F.P.C. 33, 38-9 (1946), which is also cited in this connection, is not different from the aforementioned decisions involving equitable allocation of interest expense. Not only is this apparent from the Commission's perfunctory dis-

[24] In *Michigan Wisconsin Pipe Line Co.*, 13 F.P.C. 326, 358-9, 373 (1954), to which Memphis also refers, there is nothing in the Commission's opinion to reveal the basis of the reduced tax allowance. However, inasmuch as the company there did not question the propriety of a reduced allowance but merely the amount thereof (13 F.P.C. at 373), there is a strong presumption that, as in the cases discussed in the text, the tax adjustment was merely the means for allocating to Michigan Wisconsin the portion of the deductible expenses incurred on its behalf by its parent. In any case, inasmuch as the propriety of the Commission's action was not questioned, that case obviously does not constitute a precedent.

cussion of the income tax issue in that opinion, but, indeed, the Court of Appeals for the Fourth Circuit has so construed the decision. *South Carolina Generating Co.* v. *F.P.C.*, 261 F. 2d 915, 920 (4th Cir., 1958).[25]

B. The Decisions Dealing With the Problem Here Presented Fully Support the Court Below

In contrast to the several Commission cases which are relied on by Memphis and the Commission and which are clearly distinguishable, the case which the Commission would now classify as the exception to its alleged prior "consistent practice", namely, *Olin Gas Transmission Corp.*, 17 F.P.C. 685 (1956), is the *only* prior Commission decision (other, of course, than *Cities Service*) specifically dealing with the issue here presented. In that case, the Commission recognized the impropriety of bestowing upon the customers of the jurisdictional company in the form of reduced rates the benefits of the tax losses incurred in connection with non-jurisdictional activities of an affiliate.

Thus, in the *Olin* case, the parent of the jurisdictional company had filed a consolidated tax return for

---

[25] Interestingly enough, in the *South Carolina Generating* case, from which the Commission seeks also to derive some comfort (Br., p. 22 fn. 23) the Court of Appeals held that "the actual costs should not be disregarded simply because the selling utility chooses to incur them in one place rather than another" (261 F.2d at 920), after earlier noting that the Commission "took into account only the income taxes which the Generating Company is obliged to pay as a separate corporate entity but failed to include the additional tax incurred by the corporate system as a whole because of the establishment and operation of the subsidiary body" (261 F.2d at 917).

Similarly irrelevant here are the cases cited in the Commission's Petition for Certiorari (at p. 8, fn. 13), since they do not involve non-jurisdictional tax losses.

1954 in which, because of the tax losses of the parent's non-jurisdictional operations, no tax had been paid. The argument was made that no tax allowance should be included in the jurisdictional company's cost of service. The Presiding Examiner rejected the argument and held that the jurisdictional company should be allowed the full amount of taxes computed as if it had not participated in a consolidated return, stating (17 F.P.C. at 693-4):

> "* * * Olin (and its predecessor) as a corporate entity had a legal liability in the year 1954 for the payment of Federal Income Taxes on net profits from operations in the amount of $3,124,343. Such Federal income tax liability on $3,124,343 was discharged by the operation of the crediting provisions of Federal Internal Revenue laws permitting the consolidation of returns of Olin and its affiliated corporations and the crediting of net profits against net losses within the system. As a matter of fact and of law Olin satisfied its Federal income tax liability in 1954. Olin, as a matter of law, applied to it as a company subject to rate regulation by this Commission (and not as a component of a system over which this Commission has no jurisdiction to regulate rates) had a computable tax liability in 1954 of $897,537, which is recognized as a lawful revenue deduction in determining just and reasonable rates. *Any other action would penalize Olin as an affiliated member of a corporate system.*"

On exceptions to the Commission, the Commission agreed with the Examiner (*Id.* at 703):

> "* * * The reason the consolidated return reflects no income taxes for Olin was in part due to losses generated by [the parent company] from *unregulated business activities unrelated to Olin's natural gas operation. This* and other circumstances

justify the allowance for state and federal income taxes which [the applicant] has included in its jurisdictional cost of service.'"[26]

The Commission's *Olin* decision accords with those of various State courts and regulatory authorities. In *Southern Union Gas Co.* v. *New Mexico Public Service Commission,* No. 31074 D. Sante Fe County, New Mexico (June 9, 1961), the tax allowed the company by the Commission was less than that computed on the basis of the net operating income attributable solely to the company's New Mexico public utility operation, since the Commission had allowed the company only a portion of the tax calculated as "actually payable" on the company's total operations (utility and non-utility). In annulling the Commission's order, the Court held that the State Commission must compute the tax allowance for the utility operation without regard to the income tax effect of the company's non-utility operations, stating:

"The Commission erred in not determining the Federal income tax allowance by computing the amount of tax liability which is directly associated with and attributable to Petitioner's appropriate New Mexico utility operating income, before Federal income tax, without regard to the income tax

[26] While the Commission in the *Olin* case stated that the case was *sui generis* (see 17 F.P.C. at 696), that statement was addressed to the Commission's disposition there of the problem of valuing a pipeline company's own produced gas for which the Commission was then groping for a solution. This *caveat* was intended to make clear that the Commission did not regard its decision as constituting the solution to that problem and so should not be construed as a precedent on that matter. No such situation confronted the Commission there with regard to the tax issue and hence there is no reason to regard its disposition thereof as *sui generis,* particularly in light of the rationale underlying this action.

effect of Petitioner's other businesses and activities and expenses which are treated by the Commission as non-utility in character."

Similar conclusions have been reached by the Indiana, Kentucky, Pennsylvania, New York and Washington Commissions. Thus, in *Kokomo Water Works Co.*, C.C.H. Utilities Law Rep., Par. 18,513 (Ind. P.S.C., 1959), the Indiana Commission, in fixing the tax allowance for a subsidiary, refused to reflect a so-called "consolidated effective tax saving" which arose "solely from tax deductions attributable solely to the parent company or to losses sustained by other operating companies." It stated (Pas. 18,513.04):

> "We find that Petitioner's utility operations should be measured on their own, *Public Service Commission v. Indiana Bell Telephone Co.* (1956), 235 Ind. 28-29, and just as additional expenses arising from other affiliated companies could not be attributed to Petitioner, so likewise, expense deductions attributable to other affiliated companies cannot be. Petitioner's earnings must be sufficient to cover all expenses, including income taxes, attributable to its own operations, regardless of whether the owner of its stock may have deficits or deductions elsewhere to reduce its overall tax liability."

In *Re Union Light, Heat & Power Co.*, 97 P.U.R. (n. s.) 33, 40 (Ky. P.S.C. 1953), the Kentucky Commission computed tax expense for the company's gas and electric operations without regard to tax savings resulting from losses in the company's water operations. The Commission held (97 P.U.R. (n. s.) at 40):

> "Several adjustments are necessary for Federal and state income taxes. The gas and electric operations receive the benefits of certain tax savings due to the loss sustained in Union's water opera-

> tions. Inasmuch as we are considering the gas and electric operations alone in these cases, the Commission is of the opinion that these tax savings should be eliminated from the gas and electric operations inasmuch as they are assignable solely to the water operations."

In *Pub. Util. Com'n,* v. *Sunbury Water Co.,* 29 Pa. P.U.C. 321, 337-8 (Pa. P.U.C. 1951), the Pennsylvania Commission held that, in computing income taxes for the water company, it would give no effect to losses from the company's ice business. As the Commission viewed the problem (29 Pa. P.U.C. at 337):

> "* * * If a profit were realized from the ice business, unless it were negligible, we would not be justified in including that profit in determining allowable income taxes to be paid for by respondent's customers. Conversely, any loss realized would not enter into such determination of income taxes."

Similarly, the New York Commission has disregarded non-jurisdictional losses in computing allowable tax expense for jurisdictional operations. In Re *Rates and Rate Structures,* 29 P.U.R. (n. s.) 391, 481-2 (N.Y. P.S.C. 1938), involving an investigation of gas and electric rates, the Commission computed taxes separately for the profitable electric and unprofitable gas departments of the Queens Borough Gas & Electric Company. As a result, the taxes assigned to the electric department exceeded the computed so-called "actual taxes payable" in three of the five periods under review. Likewise, in *Re Staten Island Edison Corp.,* 60 P.U.R. (n. s.) 385, 479-80 (N.Y. P.S.C. 1945), the New York Commission computed tax expense of a subsidiary without regard to losses sustained by other companies in the system. It said (60 P.U.R. (n. s.) at 480):

"* * * In 1943, the company accrued $277,000 for Federal income tax purposes. The accrual represented the estimated amount of tax the company would pay in a consolidated tax return with other companies in the Associated System. Although the tax rate is slightly higher on the basis of a consolidated tax return, the amount of tax in this instance is less than what it would be under a separate return because of the benefit received from taxable losses sustained by other companies in the Associated System. For the purpose of this determination, the Staten Island Edison Corporatoin will be allowed the amount of Federal income tax it would be required to pay on the net income applicable to its electric operations on the basis of filing a separate return."

CONCLUSION

For the foregoing reasons as well as those set out in the briefs filed herein by respondents, it is respectfully submitted that should the Court reach the merits, then the judgment below should be affirmed.

Respectfully submitted,

CONRAD C. MOUNT
First National Building
Oklahoma City, Oklahoma 73101

JACK WERNER
MELVIN RICHTER
317 Wyatt Building
Washington, D. C. 20005

Attorneys for Amicus Curiae

HARRY L. ALBRECHT
918 Sixteenth Street, N. W.
Washington, D. C. 20006
Of Counsel

October 20, 1966

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 127

FEDERAL POWER COMMISSION,
Petitioner,

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, AND TEXAS EASTERN TRANSMISSION CORPORATION,
Respondents.

No. 128

MEMPHIS LIGHT, GAS AND WATER DIVISION,
Petitioner,

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, AND TEXAS EASTERN TRANSMISSION CORPORATION,
Respondents.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR UNITED GAS PIPE LINE COMPANY

Of Counsel:

W. O. CRAIN
General Counsel
P. O. Box 1407
Shreveport, La. 71102

K. W. KOLBE
2 Rector Street
New York, N.Y. 10006

LYNN R. COLEMAN
2024 First City National Bank Building
Houston, Texas 77002

THOMAS FLETCHER
2025 First City National Bank Building
Houston, Texas 77002
Attorney for United Gas Pipe Line Company

October 20, 1966

FIDELITY PRINTING COMPANY, INC., HOUSTON

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Respondents.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR UNITED GAS PIPE LINE COMPANY[1]

[1] In this brief, reference will be made as follows: Federal Power Commission, FPC; Memphis Light, Gas and Water Division, Memphis; United Gas Pipe Line Company, United; Union Producing Company, an affiliate of United, Union; United Overseas Production Corporation, an affiliate of United, Overseas; United Gas Corporation, parent of United, Union and Overseas, Corporation; Natural Gas Act, Act; R will refer to the printed record in this Court, thus R I 4 cites Vol. 1 of the Record at page 4, etc.; CR will refer to the Certified Record but not brought forward in the printed Record in this Court; reference to Petitioners' Briefs, i. e., FPC 2 or Memphis 2, will refer to FPC Brief, page 2, etc. All emphasis is supplied unless the contrary be noted.

COUNTER-QUESTION PRESENTED

Where a group of affiliated corporations, including United, files a consolidated Federal income tax return reflecting oil tax deductions and losses of United's affiliates, Union and Overseas, arising from non-utility operations which are not subject to the jurisdiction of the FPC, are wholly unrelated to the operations of United, and are not reflected in United's cost of service:

May the FPC utilize such oil tax deductions and losses to reduce the Federal income tax component includible in United's cost of service on which United's rates for the sale of gas, regulated under the Act, are based?

STATUTES INVOLVED

In addition to those listed by FPC, the following: § 1(b) of the Act; from the Internal Revenue Code of 1954, (26 USC 1 et seq): § 11(a), (b), (c); § 172(a), (b), (c); § 1503 (c)(1)(A), (B); and the following Regulations,[2] 26 CFR: § 1.1502-15(a); § 1.1502-30(a); § 1.1502-31(a)(1), (b)(1), (2); § 1.1502-34(a), (b), (d); and § 1.1502-35 — set forth in Appendix A.

COUNTER-STATEMENT

FPC Opinion 428 (R II 32), involved increased rates filed by United under § 4(d) of the Act. In computing Federal income tax component in United's cost of service, the FPC substituted for the applicable statutory corporate tax rate, a lower so-called "consolidated effective tax rate"

[2] On September 8, 1966, retroactive to January 1, 1966, changes in some regulations became effective. Citations in this brief will be made to the regulations applicable to the pertinent period involved here.

attributable to United's joinder with its affiliates in a consolidated Federal income tax return filed by their parent, Corporation.

This computed "consolidated effective tax rate" of 50.04% used by FPC instead of the statutory 52% rate, gives United's jurisdictional *gas* customers the benefit of tax deductions and losses which are not United's but which belong to Union and Overseas, and arise solely from the latters' *oil* operations, (App. D; R II 24), over which everyone agrees the FPC has no statutory control.

Pursuant to § 19(b) of the Act (15 USC 717r(b)), United petitioned the Fifth Circuit to set aside Opinion 428 and Opinions 428-A and 428-B on rehearing. The FPC approved a settlement, 32 FPC 1515, which removed all issues save that of the consolidated tax (R II 57).

Background. United, its parent, Corporation, and Union, another subsidiary of Corporation, filed consolidated tax returns during the FPC's "representative period" (1957-1961), being joined in 1961 by a third subsidiary, Overseas (R I 24, 37, 40).

Corporation owns all the outstanding stock and long-term indebtedness of its three subsidiaries, and operates natural gas distribution systems in Texas, Louisiana and Mississippi (R I 40-3). United is a natural gas transmission company purchasing, transporting and selling natural gas in intrastate and interstate commerce for resale and also for direct industrial consumption (R I 40-1). Union is in the business of exploring, developing, and operating oil and gas properties. It sells most of the natural gas it

produces to United (R I 40-2).[3] Overseas operates entirely outside of the United States, being engaged in oil exploration operations in Africa (R I 41-2).

The operations of Corporation, United, Union, and Overseas are separate and distinct, and are of an entirely different nature from the operations of each of the others. (R I 39-42).

Corporation is not subject to FPC jurisdiction; but its distribution business is subject to regulation by State agencies in Mississippi, Louisiana and Texas (R I 41-3).

United's interstate sales for resale — approximately 44% of its sales (FPC 3; R II 54) — are regulated by the FPC. United's intrastate sales to town borders in Louisiana are regulated by the Louisiana Public Service Commission, those in Texas are subject to regulation by the Texas Railroad Commission, those in Mississippi by the Mississippi Public Service Commission. These intrastate sales are not regulated by the FPC. Direct sales to industrial customers generally are not regulated (R I 42-3).

Union's interstate sales of gas for resale are regulated

---

[3] The FPC (FPC 4, and fn 5) says Corporation-United-Union constitute "an integrated gas utility system from well-head to consumer's premises", emphasizing that 80% of Union's gas goes to United, who in turn furnishes Corporation with 96% of its supply. This is a meaningless exaggeration.

Using the same sources FPC refers to, and its concession that this 80% is only 11% of United's supply (p 3 of its brief in the Court below), the facts are shown to be: The 80% of Union's gas sold United is 11% of United's supply. In 1964 Corporation sold a total of 95 billion cu ft. 96% of 95 billion cu ft is 91.2 billion. In 1964 United sold 1,438 billion cu ft. Thus the 91.2 billion cu ft sold by United to Corporation is 6.34% of the gas sold in 1964 by United. 11% of such 6.34%, or less than 1% of the gas sold by Union to United traveled from Union's well-heads to Corporation's burner-tips through the facilities of the three companies. The true facts destroy the picture the FPC would like to create.

by the FPC. Union's sales of oil and intrastate sales of gas, which constitute the majority of its business, are outside FPC jurisdiction, and are not regulated (R I 42, 44-5).

Every sale made by United or Union subject to FPC regulation is made under a contract or rate schedule on file with the FPC.

Income Tax Background. Unquestionably, if United filed a separate Federal income tax return as a separate entity, its tax allowance in cost of service would be computed at the statutory rate of 52%.[4] United does not lose its separate entity or the separate identity of its gas operations under the consolidated return provisions of the tax law.

Under the Internal Revenue Code (Code) (§ 1501 to 1504 (App A, FPC and United)), a consolidated return may be filed, on election, by a common parent and its subsidiaries where the parent owns 80% of all classes of voting stock, and 80% of the non-voting stock. United's group qualifies.

The tax regulations (§ 1.1502-30(a), § 1.1502-31(a), (b), App A 4-12a), preserve the separate corporate identity by defining consolidated income, on which the tax computation is made, as a *combination* of taxable incomes, computed separately, of the members of the group. Obeying these provisions, each company in United's group prepares a return on a separate basis (R I 56), and delivers it to the parent. The taxable income for each of the companies on a separate return basis for years 1957-1961 is shown at R II 5-16. Taxable income on a separate company basis after elimination of certain intercompany transactions for

---

[4] The corporate statutory rate for the "representative period" here is 52%. Under the 1964 Revenue Act, the rate is 50% for 1964, and 48% for years thereafter.

consolidated return purposes, as used in Ex 36 (Revised) (R II 24) and used by the FPC in Op 428 (R II 53) for the years 1957-1961 is shown in Appendix B.

By Reg. § 1.1502-15 (App A 4a) each member joining in the consolidated return is severally liable for the total consolidated tax, even though such member might have no tax on a separate return basis.

The FPC Decision. The majority declared complete factual similarity between United's case and *Cities Service Gas Co.*, Op 396, 30 FPC 158, stating: *"The question here involved has already been determined by us in Cities Service Gas Company"*. The FPC directed application of the *Cities Service* procedure to compute United's "consolidated effective tax rate" (R II 41-2, 53; See App C).

The FPC states that this "procedure" was "recently enunciated in *Cities Service Gas Co.*, 30 FPC 158" (FPC 7) contrary to Memphis' claim that the FPC was following its "established administrative practice * * * *most* recently reflected in * * * *Cities Service* * * *" (Memphis 9). The prior FPC cases cited (Memphis 15) are said to represent this established practice, but none of these cases involve non-jurisdictional losses of affiliates. (See, App. C, 26-7c). This dichotomy of position reveals that the reaching out for non-jurisdictional losses is a new ploy requiring new and previously unpossessed powers.[5]

In their dissents, Commissioners O'Connor and Woodward concluded the 52% statutory rate should be utilized

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[5] It is new in the sense that the FPC has not previously so held. The issue, however, was before the FPC in *Olin Gas Transmission Co.* (1957) 17 FPC 685, 693-4, 703, and was decided in accordance with United's contentions, (but cf the caveat at p 696 — not deemed to affect the tax holding). To the same effect, see p 51-74 of the Examiner's decision in *Tennessee* (G-19983, dated May 28, 1962, unpublished.)

for the reasons in their dissent in *Cities Service,* which they adopted (R II 55).

Their *Cities Service* dissent stated that utilization of the consolidated effective tax rate would frustrate Congressional intent underlying the consolidated return provisions of the law; that the use of the effective tax rate theory appropriated losses which derived from expenditures in non-jurisdictional business activities financed not by the regulated gas company's customers, but rather by stockholders; that the customers of the gas company would receive a windfall while the company itself obtained no benefit from inclusion in the consolidated return; that it had the effect of regulation by the Commission of non-utility enterprises beyond the Commission's jurisdiction; that the Commission decision was based on the false premise that it had the power, which "clearly" it did not have, to amend § 1501 of the Code and to limit the effect of the mandate of Congress expressed in that section; and that the Commission's action resulted in a clear deprivation of property without due process of law in that it took away from non-utility companies included in the consolidated group valuable property rights which belong to said companies (App C, 26c-36c).

The Judgment of the Court of Appeals. In the Fifth Circuit, United asserted direct, unequivocal support for its contentions in the Tenth Circuit decision in *Cities Service Gas Co.* v. *FPC* (1964) 337 F 2d 97 (FPC App B), involving precisely the same issue before the Fifth Circuit.

The Tenth Circuit reversed and set aside the "method" devised by the FPC in *Cities Service,* which it purportedly applied to United. The Tenth Circuit held that "No 'tax savings' resulted from the inclusion of the Gas Company in the consolidated return" (FPC App B, 38); that "We think

it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent company" (FPC App B, 37); and after demonstrating that "the reduction in the total tax liability effected by the consolidated returns is due to the losses of the nonregulated companies", it concluded:

> "It is thus plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the Act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside." (FPC, App B, 39).

The Fifth Circuit studied this record and the Tenth Circuit decision, and concluded:

> "United would have us follow the Tenth Circuit's *Cities Service* decision. The Comission says that the *Cities Service* case is to be distinguished because of fact differences. It urges that the Tenth Circuit decision is wrong and should not be followed. We do not think there are any such fact differences between *Cities Service* and this case as call for the application of any different rule of decision. The Court in the Tenth Circuit case held that the tax allocation as made by the Commission's order was contrary to the requirements which Congress had imposed. We think the Tenth Circuit case is correct and that the principles which are announced in its opinion are here applicable and controlling. The Commission's order, using an incorrect income tax rate in computing cost of service for the fixing of United's gas rates is erroneous and must be vacated and set aside." (R II 71-2)

Thus, two Courts of Appeals are unanimous in holding the FPC orders unlawful in the jurisdictional aspects noted.

This upheld the two Commissioners who dissented in the *Cities Service* and *United* proceedings. We find no court decision to the contrary.

SUMMARY OF ARGUMENT

I.

Both in the Petition and brief, the FPC admits that its purported "allocation formula" does transfer the entirety of the "tax losses" which the FPC equates to "tax savings", from *non-jurisdictional unregulated* activities to the *regulated* members of the consolidated group, i.e., United and Corporation. This confesses the jurisdictional "transgression" which the Court below adjudged to result from the FPC failure to separate, as the Act requires, the regulated from the non-regulated profits and losses. It necessarily follows that the judgment below was right.

To rescue itself, the FPC suggests that its decision might be reinstated on the basis of a "sharing of benefits" idea. But analysis of the so-called "sharing" concept demonstrates conclusively that it would itself result in the identical jurisdictional violation, as that confessed and adjudged; and that, considered against the facts and circumstances of this case, there is nothing to "share".

Such admission by the FPC, without more, warrants affirmance by this Court of the judgment of the Court below.

II.

The 52% tax rate applicable here is prescribed by statute. That rate must be applied to United's taxable income to compute the Federal income tax component in United's cost of service, to recoup which, its jurisdictional rates are set.

The "consolidated effective tax rate" of the FPC is a contrived device, without statutory sanction. Under the FPC technique, the jurisdictional customers of United receive the benefit of unrelated, non-utility, non-jurisdictional oil losses belonging not to United, but to its affiliates Union and Overseas — losses issuing from operations in which FPC exhibits neither interest nor use in aggregating United's jurisdictional rate base and cost of service for rate making purposes. Union's gas operations for the representative period had an aggregate net taxable income, so that the oil operations of Union and Overseas necessarily were the sole source of those "benefits" appropriated for United's jurisdictional customers, who contributed nothing to their existence. In so doing, the FPC, under the guise of "allocation", broke out of the jurisdictional bounds fixed by Congress in the Act, to invade and seize operations beyond its jurisdiction.

The carryback, carryforward provisions of the Code ensure that Union can utilize its own tax losses. There is, thus, no basis for any treatment of United save to compute its income tax component in its cost of service by application of the statutory corporate income tax rate to its own taxable income.

Apart from the illegality of the FPC technique, this record indisputably shows that had the FPC done what its formula purported to require, Union's and Overseas' oil tax deductions and losses would have been more than offset by unregulated taxable income, which confirms the demonstration that the FPC, as United contends and the Court below held, must and can only compute United's income tax component solely from its own separate taxable income times the statutory tax rate.

The Court below, following the path of construction of

the Act laid out by this Court, correctly set aside the order complained of.

III.

Petitioners present nothing contrary to the foregoing:

A consolidated tax is not a joint cost. Thus, no "allocation" is indicated or permissible. A consolidated tax is a function of the separate taxable income of each corporation times the statutory tax rate. This separate and individual function is not disturbed, but retained by the consolidated return statutes and regulations. Thus the tax liability of United is derived from its own operations, and is a direct cost to it. The Court below properly so held.

United's customers make no contribution to Union's oil costs, as FPC and Memphis claim, for the FPC in Union's case carefully separated out all oil costs to obtain a jurisdictional cost of service for gas alone. It approved settlement rates which would recoup only that jurisdictional gas cost of service. It is these settlement rates that United pays Union.

No basis appears to support the FPC claim that the purpose of consolidated returns was to pierce the corporate veil. On the contrary, the courts hold that consolidated return provisions preserve the separate corporate entity. FPC jurisdiction does not depend on corporate form, but on the presence of those things expressly conferred to its authority by Section 1(b) of the Act.

The Memphis claim of rate increase to its customers, should the decision of the Court below be affirmed, is without any substance.

ARGUMENT

I.

The FPC Admits the Jurisdictional Violation Adjudged.

The essence of the holdings of the Fifth and Tenth Circuits is that the FPC tax "allocation" is unauthorized and unlawful for failure to comply with the jurisdictional requirement for the separation of regulated and non-regulated profits and losses which Congress wrote into the Act (R II 71-2; FPC App. B 39).

In its Petition (p 10, fn 8), the FPC concedes that its "formula * * * *may* result in allocating the *entire* tax saving resulting from *losses* of *unregulated* activities to the *regulated* members of the consolidated group." But in its brief (p 15) it advances from the timidity of "*may*" to the flat, unqualified admission that its formula "(* * * applied to the facts of this case, results in allocating the *whole* of the savings to the companies that had taxable income)" i.e., United and Corporation.

Thus the FPC confesses the jurisdictional transgression which the Court below adjudged.

The FPC seeks to retrieve by suggesting that its decision might be supported by an alleged propriety of some character of a "sharing" of the "benefits" of the non-jurisdictional tax losses. The short answer is that any "sharing," particularly as the FPC here seeks with United's jurisdictional customers, would be unlawful, for it would produce the identical jurisdictional transgression for which the Court below vacated and set aside the instant order. The second short answer is that the FPC by its own confession has appropriated "the whole" of these non-jurisdictional tax losses — leaving nothing to share.

Furthermore, as we demonstrate, see p. 20-1, *infra*), Union can utilize its own tax losses.

Finally, the FPC brief itself exposes this "sharing of benefits" idea as specious. For the FPC declares (FPC 6) that the taxable income of the parent corporation for the representative period was $9,024,170 — almost three times the aggregate of Union's and Oversea's non-jurisdictional oil tax deductions and losses of $3,894,060. Corporation, the sole investor in Union, is clearly entitled to all of the "benefits" of such losses, because of the provisions of the tax regulation governing adjustment of Corporation's tax cost basis in Union (see p 22, 32; see App A 12-7a, *infra*). Also, even if the FPC had followed its own unlawful "allocation formula", as it purported to do, the unregulated income from non-jurisdictional activities would more than have absorbed such losses (see p 31-2, fn 13, *infra*). In each and all of these events, there could be nothing to "share".

In our respectful submission, the unqualified concession by the FPC of the jurisdictional transgression which the Court below decreed, warrants, without more, affirmance of that judgment.

II.

The "Consolidated Effective Tax Rate" and Its Unlawful Impact on United. Tax rates are prescribed only by statute. There is no authority under the Internal Revenue Code prescribing or authorizing a so-called "consolidated effective tax rate." A Federal income tax results from two factors: (1) The prescribed statutory tax rate — here 52%, and (2) a properly determined amount of taxable income to which the statutory tax rate is applied. 26 USC 11. A consolidated effective tax rate is a contrived device wholly beyond statutory sanction.

Here the FPC did not even follow, as it purported to do, its illegal *Cities Service* three-step procedure (R II 41). Instead, it compounded its unlawful action by dividing the

consolidated tax between United and Corporation in the ratio of their respective taxable income to the consolidated income. Then it related the amount assigned United to United's taxable income to derive the 50.04%.[6] The 50.04% rate is a fiction — the result of a contrived device — under which United's customers improperly receive the tax benefit of deductions from sources other than United's own operations.[7] This record indisputably shows the sources of these deductions to be $3,869,626, the net loss from Union's *oil operations* (App D), and $24,354, the net loss from Overseas' *oil operations* (R II 24).

In the FPC computation of United's income tax component (R II 53), 92.11% of the consolidated tax is attributed to United since that is said to represent its average income contribution to the group over the representative period (1957-61). This is supposedly done to "allocate" actual taxes paid. But if 92.11% of the non-

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[6] This is exactly what Staff did in *Cities Service*. The FPC rejecting it as "artificial" and "instable" for rate-making, thus described it:

"In effect, Staff's effective tax rate is derived by taking the ratio Gas Company's income bore to the total income of the profit making companies, and applying this percentage to the system tax paid." (United App C, 7-8c)

[7] In Memphis' brief below at p 30 there appears Appendix A which shows that for the year 1958 all companies included in the consolidated return were in a taxable income position, and further that the "effective tax rate" for United in that year was 62.017%. The FPC's order would head off a two-way application of its formula by the stricture "that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate-making purposes, *if computed on a separate return basis.*" (i.e., 52%) 30 FPC at 164. In this event, who would bear the 10% difference?

Thus where non-jurisdictional operations of an affiliate result in a taxable profit, the FPC beats a hurried retreat to the concept of the pipeline company as a separate entity incurring a separate tax liability at the statutory rate. And thus does the FPC refuse to play ball both ways, the rules of the game depending on who benefits.

jurisdictional net tax loss from Union and Overseas is subtracted directly from United's taxable income, and this reduced figure is then multiplied by 52%, *or*, if 92.11% of this net tax loss is itself multiplied by 52%, and then subtracted directly from United's income tax computed separately at 52%, the answer in each case is the same as the amount computed by applying the so-called "consolidated effective tax rate" of 50.04% to United's taxable income of $105,290,983 adjusted by $396,875 for capital gains and surtax exemptions. Thus even casual scrutiny reveals that the FPC formula is not one to "allocate" taxes paid but one to divide up non-jurisdictional losses.

In actuality, under this device, United's jurisdictional customers receive the benefit of $380,698[8] annually, from sources other than United's own operations, i. e., the unrelated, non-jurisdictional, non-utility oil operations of companies other than United included in the consolidated return.

The FPC Order Exceeds its Jurisdiction. It is a fundamental principle recognized by this Court, that non-utility losses or deductions arising from non-jurisdictional operations must not be considered for rate-making purposes.

Thus, this Court stated in *Panhandle Eastern Pipe Line Co.* v. *FPC* (1945) 324 U S 635:

> "We agree that the Commission must make a separation of the regulated and unregulated business when it

[8] Recomputing Op 428, App 4 (R II 52), at the 52% statutory tax rate instead of 50.04% results in a $760,936 increase in overall cost of service. Allocation to classes of sales on the basis of Op 428, App 6 (R II 54), results in a $380,698 increase in jurisdictional sales. In other words, the taxable income figure used by the FPC is $380,698 less for its jurisdictional customers under the 50.04% rate than would be the case under the 52% rate.

> fixes the interstate wholesale rates of a company whose activities embrace both. Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which Congress wrote into the Act." (p 641-2)

The FPC may not regulate oil operations. §1(b) of the Act

Accordingly, Union's plant investment devoted to the production of oil is not included in United's rate-base upon which its return is computed, nor are Union's costs attributable directly, or by allocation, to its oil operations used to *increase* United's cost of service. This is proper. The FPC, however, would then latch on to the tax consequences of those same non-jurisdictional operations to *decrease* United's cost of service for the purpose of reducing rates to United's jurisdictional customers. This makes no sense, regulatory or common.

The FPC has a range of discretion in selecting a method for allocating costs between jurisdictional and non-jurisdictional operations. *Colorado Interstate Gas Co.* v. *FPC* (1945) 324 US 581, 589; *Panhandle Eastern Pipe Line Co.* v. *FPC, supra.* But the clear limits of that range of discretion were spelled out in *Colorado Interstate*:

> "Colorado Interstate and Canadian object to the Commission's use of the return. The Commission included in the total cost of service for these companies a 6½ per cent return on the rate base. In other words, the 6½ per cent return was computed on the basis of all the property used by petitioners in their various classes of business — intrastate sales, direct industrial sales, and interstate wholesale sales. Now it is apparent that if the reduction ordered was based on the excess of revenues from all classes of business over the aggregate costs, the result would be to reduce to a common level the profits from each class. In that case, whenever a

company was making a higher return on its unregulated business than the rate of return allowed for the regulated business, the excess earnings from the unregulated part would be appropriated to the entire business. When the unregulated business was being operated at a loss or at less than the return which was allowed, excess earnings from the regulated business would be appropriated to the unregulated business. A low rate might therefore be concealed by siphoning earnings from the unregulated business; a high rate rate might be built up by making the regulated business share the losses of the unregulated one." (p 593-4)

The clear direction set out by this Court in the *Panhandle Eastern* and *Colorado Interstate* decisions is highlighted by the analysis of a thoughful judge in terms which illuminate this particular case. See *Mississippi River Fuel Corp.* v. *FPC* (CADC 1947) 163 F 2d 433, 439. The same case (p 448) approved the FPC action on income taxes. That action evidences a recognition which the FPC could well have emulated here,

"No attempt is made to limit the return from the business which is beyond our jurisdiction. In making a cost of service study, it is necessary to determine the expenses on an over-all basis before they can be properly allocated. One of the expenses which must be calculated on an over-all basis is the income tax. The tax is determined by the taxing authorities with reference to the business as a whole and that, necessarily, must be our starting point. For the purposes of simplicity as well as accuracy of the computation, the income tax is computed at what it would have been if the return on the company's entire business were limited to 6 percent, the reasonable rate of return for the jurisdictional business. When a tax computed in this manner is allocated, automatically the amount assigned to the jurisdictional business equates to the tax which is associated with the 6 percent return on that business. It should be emphasized that the cal-

> culation is made solely for the purpose of determining the tax which applies to the regulated business. The Company by reason of higher, [or lower], earnings, may pay a much higher, [or lower], tax on its non-regulated business, but this, under the Natural Gas Act, is no concern of the Federal Power Commission." (*Mississippi River Fuel Corp.*, (1945) 4 FPC 340, 355-6)

Though the FPC recognized in this case the principle of effective separation (R II 48), it inconstantly ignored this principle in its computation of United's tax allowance. Such conduct repudiates the principle laid down by this Court in *Panhandle Eastern* and *Colorado Interstate, supra,* as was correctly appreciated by the Fifth and Tenth Circuits.

Nature of Union's Operations Requires Separation Between Jurisdictional and Non-Jurisdictional Costs and Revenues. Consistent with the basic rate-making principle that jurisdictional and non-jurisdictional costs and revenues must be separated, United contends that the tax losses and deductions arising from Union's unrelated, non-jurisdictional and non-utility oil operations, which are wholly disassociated from United's gas operations, cannot be taken into account in computing United's tax allowance in cost of service.

As noted, Union's net loss from oil operations for the period 1957-1961 was $3,869,626. This reflected $9,617,865 (R II, 17-21, col. 10, line 24) of intangible drilling costs of producing *oil* wells, without regard to the loss carry-back and carry-forward provisions of the Code, (App A, § 172), and without regard to the fact that Union has more than ample proven oil and gas reserves to insure that it could utilize all of its tax losses and deductions if it were to file separate tax returns (R I 61, 67-9, 71-2).

During the five-year period 1957-1961 Union's gas operations produced aggregate net taxable income of $507,254. (App D). Thus, Union's gas operations did not give rise to tax losses.

This leaves only Union's oil losses for FPC appropriation under the technique of the consolidated effective tax rate. After Union's gas operations are excluded, the net aggregate tax loss which the FPC would give to United's customers arises solely from Union's unrelated, non-jurisdictional, non-utility oil operations, in the amount of $4,376,880 (App D), and $24,354 from Overseas oil operations (R II 24), aggregating $4,401,234.

Union's and Overseas' oil operations are wholly outside the FPC's jurisdiction and the tax results stemming from those operations should not be reflected in United's regulated cost of service. Not only are these oil operations irrelevant to the interstate resale of natural gas; the Act, without exception, prohibits use of them by the FPC in rate determination for jurisdictional gas.

The consequent impact on United, and its jurisdictional customers, of this forbidden focus on Union's oil situation would surely be rate instability — rising or falling with Union's oil tax deductions and losses, over all of which the FPC has no control and in which such customers have no interest.

Both the FPC and Memphis place heavy reliance on *El Paso Natural Gas Co.* v. *FPC* (5 Cir. 1960) 281 F 2d 567, cert. den. 366 U S 912 (FPC 25, 27; Memphis 5, 19-20). United recognizes, as it advised the Court below, the force of *El Paso* and needs but point out that the Fifth Circuit, in holding for United, obviously found no inconsistency with *El Paso* and its position below.[9]

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[9] Indeed, one member of the panel below also sat in *El Paso*, and significantly no mention of *El Paso* is included in the decision below; nor was *El Paso* mentioned by the Tenth Circuit in *Cities Service*.

United's case is completely distinguishable from *El Paso*. First, the consolidated effective tax rate issue was not involved in *El Paso*. Second, *El Paso* did not attempt to reduce gas rates by utilizing tax losses and deductions from El Paso's *oil department* operations. On the contrary, the FPC in *El Paso* carefully separated out all *oil* and other non-utility operations — including the tax consequence thereof — thus leaving only jurisdictional *gas* operations.[10] The tax expense in *El Paso* reflected the statutory depletion and intangible drilling allowance relating solely to the *natural gas operations* of the company. The lesson of *El Paso* is clear and simple: It restricts the authority of the FPC over tax deductions to jurisdictional gas operations and business.

Union can Utilize its Own Losses. For the five-year representative period, 1957-1961, Union was in a taxable income position in its gas operations while its oil operations resulted in a loss for tax purposes. On a separate return basis, Union would have the right to carry-forward for five years and back for three years, any loss for a given year as an offset to taxable income in any of the eight years. (§ 172(b))

The eight year period affords wide latitude for a corporation to recoup its prior losses. The record in this case shows that Union, on a separate return basis, would have been able to utilize all of its tax losses, incurred during the five-year representative period, under the carry-over provisions of the Code (R I 71-2).

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[10] Memphis' equation of its one corporate entity with production department hypothesis (Memphis 19) to United-Union, with the statement that "no one for one moment would think of suggesting" disregarding tax deductions from "production operations" is forgetful of the fact that in *El Paso*, "no one for one moment" thought of *including* oil tax deductions.

Inasmuch as all of Union's tax losses, including oil as well as gas losses, could be offset against its own separate income in prior or subsequent years, there would be nothing available from the oil operations to give to United's gas customers (R I 67).

United Does not Profit from Union's Losses. The FPC's position is based upon the wholly irrelevant circumstance of a consolidated tax return. Such position could not be urged absent such consolidated return. The fallacy in the FPC's position is exposed by the fact that United's taxable income based on its allowable rate of return and its own tax deductions gives rise to a tax computed at the 52% statutory rate irrespective of whether United's taxable income is included in a separate return or a consolidated return.

The impact of the tax burden at the 52% statutory rate on United's taxable income, unreduced by Union's losses, demonstrates that United does not profit from Union's losses. No provision of the tax law or regulations governing the filing of consolidated returns and the computation of tax thereunder channels the tax effects of Union's losses to the benefit or reduction of United's tax on its own taxable income.

Under the FPC theory, there would be appropriated to United's customers the benefit of whatever results flow from the filing of a consolidated return, even though such results have their origin in losses and deductions which are wholly extraneous to United's operations. Since the FPC does not include these non-jurisdictionall costs in United's cost of service, why should the tax effect of those costs be inserted in the computation of the tax component included in United's cost of service?

United's customers have not contributed one dollar to Union's losses. The stockholders of Corporation have supplied the capital, the use of which gives rise to Union's tax losses. A tax loss does not generate profit. A loss merely affords a means of partial recoupment specified by the tax law. There is no justification either at law or in equity why the burden of the loss should be borne by the supplier of the capital while such recoupment of the loss flows to others who have assumed no risk, who have contributed no capital, and who are not entitled to any profits which ultimately may succeed the earlier losses. Not only do the stockholders assume the risk of loss on the venture itself; they pay the price the Regulations exact (Reg. 1.1502-34; 1.1502-35.)[11] See, generally, discussion in Peel, Consolidated Tax Returns § 14.02 and § 14.03, p 199-216.

The courts, the tax law and the tax regulations recognize, even if the FPC does not, the true effect of an affiliate's loss in consolidated returns. The loss is related to the parent company's investment in the affiliate. The loss does not confer any benefits or profit on any of the affiliates in the consolidated group.

On the other hand, inclusion of United in the consolidated return effects no tax saving for the consolidated tax payable is increased by exactly 52% of United's separate taxable income. This can be vividly demonstrated by using exactly the same type of schedule, which the Court in *Cities Service* employed.

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[11] This price is a pro-tanto reduction in the tax cost basis of Corporation's investment in Union measured by tax losses which Union itself could not recoup.

Year	(1) Consolidated Tax — Including United*	(2) Consolidated Tax Excluding United**	(3) United's Separate Tax at 52%***	(4) Sum of (2) plus (3)
1957	$13,560,947	$ 240,742	$13,320,205	$13,560,947
1958	16,091,376	4,352,910	11,738,466	16,091,376
1959	11,356,973	470,069	10,886,904	11,356,973
1960	8,250,373	(885,735)	9,136,108	8,250,373
1961	7,940,211	(1,721,131)	9,661,342	7,940,211
Total	$57,199,880	$ 2,456,855	$54,743,025	$57,199,880

*After adjustment for capital gains. (R II 53.)

**This amount is determined by subtracting United's taxable net income as it appears at R II 24 (as adjusted for capital gains), from the consolidated taxable net income appearing at R II 24 (as adjusted for capital gains) and multiplying the difference by 52%.

***This amount is determined by multiplying United's taxable net income (R II 24), as adjusted for capital gains (R II, 11, 15) by 52%.

The above schedule demonstrates conclusively that inclusion of United in the consolidated return, for each of the years in the five year period, increased the consolidated tax liability of the entire affiliated group by 52% of United's income included in the consolidated return — so that no "tax savings" resulted from inclusion of United in the consolidated return. This is the exact situation present in *Cities Service*.

The aggregate consolidated taxable income figure for the consolidated return group for the "representative" five year period, after adjustment for capital gains, was $110,052,655 (R II 53), of which United's portion, after adjustment for capital gains, was $105,275,049 (R II 53, II 11, II 15). The statutory tax rate throughout the period was 52%. 52% of $110,052,655 (after adjustment for surtax exemption) is $57,199,880, and 52% of $105,275,049 is $54,743,025. There can be no doubt that $57,199,880 was the tax liability on the combined taxable income of all the companies for

the five year period. Similarly, there can be no doubt that $54,743,025 of such aggregate tax was United's tax liability to the Government in respect of its own separate taxable income. This amount is the result of applying the 52% rate to United's own separate taxable income. This is no "fictitious" or "hypothetical" tax. Therefore, it is indisputable that a tax on United's own separate taxable income, (for the five-year "representative" period utilized by the Commission in seeking to impose a consolidated effective tax rate), at the rate of 52% was in fact paid.

The Tenth Circuit summarized the record before it in an identical schedule (FPC App B 38,) from which it concluded,

> "The simple fact is that the tax liability of the Gas Company as reflected in the consolidated returns was not hypothetical, but an actual cost to the Gas Company." (Id).

Memphis, calling this schedule a "mathematical exercise", seeks to demonstrate its "fallacy" by an erroneous computation based upon an incomplete assumption (Memphis 25-7).

This assumed example not only disregards the tax loss carry-forward and carry-back provisions of the Code, it disregards the vitally necessary distinction between jurisdictional and non-jurisdictional, non-utility operations, which is the issue the Court decided. Using Memphis' example, and classifying correctly the corporations between jurisdictional and non-jurisdictional in the same proportions as the United group, shows the confiscation which results from the FPC's so-called consolidated effective tax rate. United is 56% non-jurisdictional; Corporation is 100% non-jurisdictional, with the portion of its operation in gas distribution regulated by various state commissions; Union is about 50% non-jurisdictional (R II 4); and Over-

seas is 100% non-jurisdictional. Corrected, the Memphis computation is:

Corporation	Taxable Net Income (Tax Loss) Total	Jurisdictional	Non-Jurisdictional
A — United	$20,000	$ 8,800	$11,200
B — Corporation	10,000		10,000
C — Overseas	5,000		5,000
D — Union	(5,000)	(2,500)	(2,500)
Total taxable net income	$30,000	$ 6,300	$23,700
Consolidated tax liability at 52% tax rate	$15,600	$ 3,276	$12,324

Memphis wrongly accuses the Fifth and Tenth Circuits of using an invalid theory to compute a fictitious tax of $18,200. These Courts did nothing of the sort. The Federal income tax liability is *52%* of taxable net income derived from jurisdictional operations, *52%* of taxable net income derived from non-jurisdictional operations, which adds to the total amount of $15,600, not $18,200, and which equates *52%* of consolidated taxable net income.

The Fifth and Tenth Circuits did not go "astray". The actual consolidated tax liability was used to show that there could be no question but that both jurisdictional and non-jurisdictional operations resulted in taxable net income which was taxed at the statutory 52% tax rate. The Tenth Circuit also showed that the tax loss carry-back provisions of the Code permit the offsetting of tax losses in the same manner as the non-jurisdictional taxable net income and income tax at 52% are reduced by non-jurisdictional operations of Corporation D — Union in the above example.[12]

[12] Memphis' suggestion (Memphis 26) that the Court's theory utilizes a "negative tax" ignores the operation of the loss carry-forward and carry-back provisions of the Code. IT 4085, cited by Memphis, relates only to the allocation of negative tax for earnings and profits purposes.

The corrected Memphis table is illustrative of the fatal defect in the FPC application of its "method" to United. The FPC flatly states "the unregulated activities in the present case produced no taxable net income" (FPC 7), but such is not true.

United's unregulated gas sales alone produced more taxable net income than its regulated sales.[18]

The FPC decision stated that "In making a separation between the regulated and non-regulated companies, we find that United is largely a regulated company, and we shall designate it as such *for the purpose of these calculations*" (R II 41). The fact is just the opposite. United is largely a non-regulated, non-jurisdictional company, and when properly classified between regulated and non-regulated activities in accordance with the FPC Op 428, every computation and statement made by the FPC and Memphis is obviously incorrect. Such is obvious because the non-jurisdictional activities of United and the entire United group produce more net taxable income than the regulated activities and there is no tax loss from non-jurisdictional activities for the FPC to allocate to jurisdictional sales.

III

Petitioners' briefs present nothing which calls into question the foregoing demonstration that the decisions of the Fifth and Tenth Circuits are correct and consistent with the decisions of this Court. Petitioners' briefs, however, contain many contentions, which in certain instances are misleading, some of which we now consider.

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[18] 1963 gross revenues were $331,167,721. (FPC Form 2). The regulated revenues were $144,598,187, or 44%. 44% of the costs were allocated to regulated sales (Op 428, App. 7, CR 9158, 31 FPC 1217). The unregulated net profit is 56% of United's total profit.

1.

The FPC apparently contends that a consolidated tax is a joint cost (FPC 12-5). Memphis echoes (Memphis 13, 14-5, 16-7) and goes beyond, boldly asserting that the FPC was not required to separate the regulated from the unregulated but only required to show a fair action. In other words, that fairness, by some mysterious alchemy became warrant to ignore and trample the jurisdictional enclosure which Congress specified in the Act. Both cite *Colorado Interstate Gas Co.* v. *FPC* (1945) 324 US 581. But that case contains neither holding nor hint that "fairness", either abstractly or in connection with a formula disguised under the name of "allocation", constitutes authority to exercise power Congress did not grant. On the contrary, that case, (see p. 16-7, *infra*) rings the bell on the same character of action in which the FPC is engaged here.

Allocation, of course, is a useful tool for the FPC to use to separate that subject to its jurisdiction from that which is not, for identification of the jurisdictional is essential to the exercise of its regulatory authority expressly conferred by the Act. This, *Colorado Interstate* recognized, but it also cautioned:

> "When Congress, as here, fails to provide a formula for the Commission to follow, courts are not warranted in rejecting the one which the Commission employs *unless it plainly contravenes the statutory scheme of regulation.*" (p 589)

See, too, *Mississippi River Fuel Corp.* v. *FPC* (CADC 1947) 163 F 2d 433, 443. That "contravention" was precisely what the Fifth and Tenth Circuits determined occurred from the "devised method" which the FPC dubs "allocation."

Further, *Colorado Interstate,* assessing the fundamental purpose of judicial review under § 19(b), concluded:

"But that review is limited to keeping the Commission within the bounds which Congress has created." (p 589)

Again the Fifth and Tenth Circuits' decisions in express terms did just that.

The FPC expressly noted its obligation, in general, to separate in its decision here, declaring:

"We think it a desirable principle of rate making that costs should be directly assigned whenever feasible, and cost allocation with all of its complexities should be employed only when necessary. As witness for the Eastern Interveners testified, jurisdictional customers should not be burdened by the costs of nonjurisdictional purchases which are not subject to regulation by the Commission." (R II 48)

Narrowing to this *tax issue,* the FPC in *Cities Service,* conceded that such separation was mandatory (App C, 7c). The Tenth Circuit noted:

"The Commission recognized the fundamental ratemaking principle which requires a separation of regulated and nonregulated profits and losses in the determination of the tax allowance. And see Colorado Interstate Gas Co. v. F.P.C., 324 US 581; Panhandle Eastern Pipe Line Co. v. F.P.C., 324 US 635." (FPC App B, 34-5)

We have demonstrated that Federal income tax for every corporation is solely the function of its own separate taxable income times the statutory rate. We have also demonstrated that this separate and individual function is not disturbed but retained by the consolidated return statutes and regulations. Thus, the Tenth Circuit concluded:

"The uncontroverted facts show that the Gas Company not only incurred a tax liability during the repre-

sentative years at the statutory 52 percent rate, but its tax liability at that rate was reported to the parent Company, *and the consolidated returns actually reflect that tax liability.*" (FPC App B, 37).

The Court below adopted the Tenth Circuit decision as applicable to, and controlling of, United's tax situation here (R II 70-2).

Certain it is that the components determining Federal income tax status, have their genesis solely in the separate business operations of each member of the United affiliated group, and not from their joint use or operation of any facility or property. The taxable income of each member of such group derives alone from the revenues and expenses of each.[14] The resulting tax liability is, therefore, a direct cost of each. The one and only impact which a consolidated return has in this context is that it has effect to require full recoupment of all tax deductions and losses in the filing year instead of the eight year period of carry-backs and carry-forwards. If there is any excess of tax deductions and losses remaining, then and only then may, recourse be had to the carry-backs and carry-forwards.

Significantly, the FPC does not contend that there is anything "joint" until after the statutory recoupment has occurred. For not until then does its so-called allocation work appropriation of the non-jurisdictional oil losses which is the purpose of what both Circuits branded a "devised method." In other words, the end result of the consolidated return procedure suddenly becomes "joint" as attempted exculpation for the appropriations which the "devised method" works.

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[14] Of course, there can be joint costs which may constitute tax deductions, but such, when they occur, are always divided in some agreed equitable fashion.

But the so-called "allocation method — the three step procedure" (FPC 9) is just camouflage as we now expose. As shown, the FPC to define that which is subject to its regulation, must separate therefrom all operations, facilities and properties not subject to its regulation. So, to the FPC, "regulated" refers alone to its regulation.

Speaking of its so-called "three step procedure", it represents to this Court:

> "Under this method, any losses sustained by an *unregulated* company or activity *must first* be set off against the total income of all *unregulated* operations." (FPC 7)

Thus, in the quoted representation, as in the first step, "(1) separate the companies into regulated and unregulated groups", (R II 41), the FPC speaks in the context of "regulated" or "unregulated" under the Act. In truth, "regulated" can have no other term of reference.

Yet, this, the FPC completely disregarded. It says United was "largely" regulated (R II 41), but completely ignored United's unregulated area, and placed United, in its entirety, in the regulated group. Except for regulation of distribution operations by State Agencies, the FPC said Corporation was unregulated. But, Corporation was placed in the regulated group (R II 41-2). Union was regulated only as to its interstate sales of gas, but the FPC said since it was in a loss position, its classification as regulated or unregulated made no difference. Overseas, the FPC said, was in the non-regulated category.

The record, however, nowhere shows a separation into "regulated" or "unregulated" groups as the first step specifies. On the contrary, the record (R II 24 and 53) indicates that the first step was skipped and that the FPC netted all deductions and losses against all income as though all members of the group were wholly regulated.

Looking at its statutory jurisdiction, and its representations to this Court (FPC 7), it indisputably appears:

(1) Corporation was wholly unregulated by the FPC, so, it should have been placed in the unregulated group. Placing it in the regulated group was error and wholly beyond the FPC's authority.

(2) The FPC regulates only United's interstate business, which it admits (FPC 3), is but 44% of United's total business. The FPC does not regulate United's intra-state business. Thus, though the FPC wields no regulation over the greater part of United's business, it wrongfully placed it all in "regulated".

(3) Only about half of Union's business is subject to FPC regulation. Its intra-state gas business is unregulated. Its substantial oil business is unregulated. The FPC admits the record permitted separation of "Union's taxable income between its regulated and non-regulated business" (R II 42). This record clearly shows that Union's gas business for the "representative" period had a taxable income of $507,254, and that its oil operations resulted in a loss of $4,376,880, with Overseas having a loss in 1961 of $24,354 (App D; R II 24).

It is readily apparent from the foregoing that a separation into regulated and unregulated groups as step (1) specified, would place far greater income to "unregulated operations". Thus, its own so-called "three step procedure" clearly exposes how illegal and unauthorized is its attempted seizure of unrelated, non-utility, non-jurisdictional oil tax deductions and losses which belong, not to United, but to its affiliates Union and Overseas.

Summation of such "unregulated income", is unnecessary, for obviously the unregulated 56% of United's operations

would produce an amount in excess of Union's and Overseas' oil tax deductions and losses. (Cf fn 13, p 26, *infra*).

Finally, using the figures which the FPC advances (FPC 6), it is clear that the figure of $9,024,170 said to be Corporation's taxable income could easily take the $3,869,626 (App D), said to be Union's "net" tax losses. This would also have statutory consistency, for Corporation, it is, which pays the prejudicial price of Union's oil tax deductions and losses by reduction of its tax cost basis to the extent of Union's unrecouped deductions and losses. (Reg. §1.1502-34; 1.1502-35, App A 12-7a).

Hence, had the FPC followed its own "devised method", as to Step (1), and made the "set off" which it represents to this Court must *"first"* be done — "against the total income of all *unregulated operations*", Union's and Overseas' oil tax deductions and losses would have been utilized completely with nothing left against United's jurisdictional portion. Obviously the FPC knows all this.

The inevitable consequence of this is to show conclusively that as the Fifth Circuit held and United contends, its tax liability is determinable by its taxable income times the applicable statutory rate.

2.

Both briefs strain to erase the jurisdictional transgressions pointed out by the Fifth and Tenth Circuits. They attempt to suggest (FPC 10, part B, 14-5, 21, 23; Memphis 12, 18, 21) that United's jurisdictional customers contributed to Union's oil operations, always undocumented, ranging from the mere existence of United's taxable income at one end, to the claim, at the other end, that Union's oil exploration costs are included in the rates United pays Union for purchase price of gas. These inferences are specious.

In *Union's* case, 31 FPC 41, the FPC noted that "Union, like most producers, produces gas from some wells, oil from others, and joint products (gas and oil, or gas and condensate) from other wells" (p 48). It then approved the Examiner's joint-cost allocation which separated all joint costs between oil and gas including all exploration and development expenses (31 FPC 48-9; Examiner, 71-3, Appendix 6, Allocation of Exploration and Development costs, 83).

In that opinion it separated and determined a gas cost of service related only to gas plant and expenses required to discharge only interstate jurisdictional natural gas business. The allocation procedures had strained out all oil costs.

The FPC thereafter approved settlement rates, 32 FPC 1506, stating they were designed to recover the jurisdictional natural gas cost of service. Thus, Union's rate schedules on file with the FPC for sale of gas to United, are referrable to "jurisdictional" gas only. Such rates have all the status and legal force of filed rates.

Accordingly, we believe this Court will perceive, realities being what they are, that in *Union* the FPC by allocation separated and divided all costs and expenses between interstate gas (regulated by FPC) and oil (unregulated and non-jurisdictional) which prevented any inclusion of oil costs on gas. For the FPC is no stranger to the truism that the smaller the overall cost of service and the more the cost allocated to oil, the lower the gas rates. How conscious the FPC is of this, is shown by its statement on another contested issue, reserve for depreciation and depletion, "The larger the depreciation and depletion reserve, the smaller the rate base, *and the less the return.*" (31 FPC 44)

Memphis (Memphis 21) and the FPC (FPC 21) say that because Corporation's capital costs are applied to both Union and United, and because Union's business is risky, United's customers pay higher rates. This is but unsupported speculation. The fact is that Memphis agreed to the rate of return which is included in the settlement of United's case (R II 33). If Memphis had objections to the rate of return as influenced by capital cost, such objections should have been brought forward at the proper time for consideration by the FPC. Such objections may not now be used as a blunt instrument to do a job on the income tax component.

Moreover, the FPC nowhere in its opinion makes any findings or any mention of capital cost as a justification for its action on the tax question. In like situations, this Court has consistently held that administrative actions must and can only be sustained upon the bases claimed as justification by the agency itself *in its order*. In *Burlington Truck Lines, Inc.* v. *U. S.*, (1962) 371 U.S. 156, this Court stated:

> "The courts may not accept appellate counsel's post hoc rationalizations for Agency action; Chenery [332 U. S. 194, 196] requires that an agency's discretionary order be upheld, if at all, on the same basis articulated in the order by the agency itself." (p 168)

This unsupported assertion is therefore not only logically irrelevant but its consideration is legally out of place here.

3.

Memphis repeatedly cites *Mississippi River Fuel Corp.* v. *FPC*, (CADC 1957) 252 F 2d 619, cert den 355 US 904, as a basis to reiterate, as an incantation, that Union is United's "producing arm" (6, 12, 17, 20, 21). It does not disclose that during the period involved in *Mississippi* Union was not regulated by the FPC.

Further, it cites *Willmut Oil and Gas Co.* v. *FPC* (CADC 1962) 299 F 2d 111, without disclosing *Willmut* referred to the same period of non-regulation as *Mississippi*.

Considering this controlling fact of non-regulation, the D. C. Circuit in *Mississippi* followed the well-settled rule that where a regulated company acquires services from an unregulated affiliate, the regulatory agency is fully authorized to scrutinize such transaction to see that it is free from any abuse because of the affiliation. Regulation furnishes the sanction against any such abuse, and itself is the guaranty of its absence.

The District of Columbia Circuit confirms this. In *American Louisiana Pipe Line Co.* v. *FPC* (CADC 1965) 344 F 2d 525, American sold 95% of its gas to two affiliates (526). This compares with the 80% which the FPC says Union sells United (FPC 4). The issue was whether American should be permitted to have a "contract demand" type of rate or whether it should have a "cost of service form". The Court defines "contract demand" form as a rate that "fixes a set price for gas in dollars and cents per unit on the basis of experience in a test year" (526). The "cost of service" form "prescribes variable rates adjusted monthly so that a pipeline recovers its actual costs plus a fixed return." (526)

Union's sales to United are made at rates expressly approved by the FPC (*Union*, 32 FPC 1506).

In *American*, the FPC opposed a change from "cost of service" to "contract demand" rate for American and rejected an Examiner's decision approving a "contract demand" form of rate. The Court said:

> "It relied exclusively on the fact that American Louisiana sells virtually all of its gas to affiliates." (527)

In Footnote 12 (532), the Court said that the FPC cited *Mississippi* to support claim that its experience and expertise "justify its special treatment of inter-affiliate transactions", but the Court held *Mississippi* was "clearly distinguishable", for there "the inter-affiliate sale was *unregulated*" (italics by the Court). *Mississippi*, it noted, told the FPC that that sale "need be set aside only upon a showing of abuse." Where the rate was "regulated by the Commission, the problems considered in that case (*Mississippi*) would be far less critical."

In Dockets G-9547 *et al.*, the FPC denied United's motion to re-open the record to meet *Mississippi's* holding, an action which the FPC confessed in *Willmut*, was error. On that *Willmut*, footnote 1 (112) said:

> "It did reopen the record to include the rate schedules which Union filed after the Phillips case [Phillips Petroleum Co. v. State of Wisconsin] 347 U.S. 672, 74 S. Ct. 794, 98 L. Ed. 1035 was decided, *but those schedules were not determinative because they were not filed until after the hearings here involved were concluded.*"

Looking at the public policy which Congress embodied in § 4(a) and (b) of the Act, and the express approval by the FPC of the Union-United contract prices for Union's gas, it seems clear that their status as filed rates is not only within the provisions of § 4(c), but they have the legality and continuity proclaimed by *Montana-Dakota Util. Co.* v. *Northwestern Pub. Serv. Co.* (1951) 341 US 246, and *T.I.M.E., Inc.* v. *U. S.* (1959) 359 US 464 — subject to change only by a new filing under § 4(d), or an FPC direction pursuant to a § 5(a) review.

In view of these considerations, the prejudice attempted to be invoked here by "affiliation" is not only out of place, but of no influential impact.

Furthermore, if the United-Union contracts in their quantity specifications furnish Union "an assured market" (FPC 11) and "an assured source of substantial profits" (FPC 10), such also is the "assured" result of all of United's purchase contracts.

Under the FPC reasoning this would give United, and in turn any pipeline subject to FPC jurisdiction, entitlement to the tax deductions of each producer-vendor. Even the FPC would not so contend, but it is a fact that the same law which provides for the Union tax losses and deductions also provides that same "generous" allowance (FPC 11) to every producer even though he be not a member of an affiliated group filing a consolidated return. (Cf FPC discussion, R II 35-6; its Union decision, 31 FPC at 43, 47; and its order approving Union's settlement, 32 FPC 1506).

4.

The FPC (FPC 25-6) states that the basic purpose of the consolidated return is the "piercing" of the corporate veil. The legislative history, including those reports cited, carefully distinguishes between the business unit or entity on the one hand, and the separate corporate entity of the affiliate corporations on the other. The Courts clearly and without restriction hold that the consolidated return provisions of the Code and its accompanying regulations do not erode and destroy, but carefully preserve separate corporate entity. *Woolford Realty Co.* v. *Rose,* (1932) 286 US 319; *Founders General Corp* v. *Commissioner* (2 Cir 1935) 79 F 2d 6; *Felbro Corp.* v. *Commissioner* (1962) 36 T. C. 864, rev'd on other grounds (2 Cir. 1963) 315 F 2d 784; *Federal Export Corp.* v. *U. S.* (Ct. Cl. 1938) 25 F. S. 109; *Trinco Industries* (1954) 22 T. C. 959; *Olivier Co.* v. *Patterson* (1957) 151 F. S. 709; *Midland Management Co.* (1962) 38 T. C. 211. See, also, the FPC's own opinion in *Olin Gas Transmission Corp.* (1957) 17 FPC 685, 695.

As we read *Burnet* v. *Aluminum Goods Mfg. Co.*, (1932) 287 US 544 cited by FPC (FPC 26) it is not inconsistent with the separate entity theory of consolidated returns. The Court of Claims agrees with us, *Federal Export Corp.* v. *U. S.*, *supra*.

The indisputable truth is that the jurisdictional prohibitions which Congress imposed on the FPC have no relationship to corporate form or corporate business save only that business prescribed as within FPC jurisdiction by Section 1(b) of the Act.

5.

Memphis views with loud alarm the increase in "the cost of gas" to "over 100,000" of its customers if the Fifth Circuit be affirmed (Memphis 4). We test this, using the FPC Op 428 test period.

The annual cost effect of a reduction in Federal income tax rate from 52% to 50.04%, using the costs, allocation procedure, and cost allocation demand and commodity volumes per Op 428, App 6, (R II 54) is as follows:

	Annual Cost
Cost Reduction to all Central and Jackson Zone Transmission Customers	$262,471
Cost Reduction to Texas Gas Transmission Corporation[15]	35,988
Cost Reduction to Memphis based on 1963 Sales of Texas Gas Trans. Corp. (Texas Gas, Form 2)	6,082
Cost Reduction to Memphis Consumers based on 100,000 customers (Memphis 4)	6 cents

In our respectful submission, the facts clearly expose the Memphis claim to be without foundation.

[15] From whom Memphis secures its gas supply (Memphis 3).

CONCLUSION

For all of the foregoing reasons it is respectfully submitted that the decision of the Court below is right, and should be in all things affirmed, and it is so respectfully prayed.

Respectfully submitted,

.....

THOMAS FLETCHER
2025 First City National
Bank Building
Houston, Texas 77002
Attorney for United Gas Pipe Line Company, Respondent.

Of Counsel:

W. O. CRAIN
General Counsel
P. O. Box 1407
Shreveport, La. 71102

K. W. KOLBE
2 Rector Street
New York, N.Y. 10006

LYNN R. COLEMAN
2024 First City National
Bank Building
Houston, Texas 77002

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Supreme Court of the United States

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Supreme Court, U.S.
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No. 127

FEDERAL POWER COMMISSION,
Petitioner,

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, AND TEXAS EASTERN TRANSMISSION CORPORATION,
Respondents.

No. 128

MEMPHIS LIGHT, GAS AND WATER DIVISION,
Petitioner,

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, AND TEXAS EASTERN TRANSMISSION CORPORATION,
Respondents.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

APPENDIX TO BRIEF FOR UNITED GAS PIPE LINE COMPANY

Of Counsel:

W. O. CRAIN
General Counsel
P. O. Box 1407
Shreveport, La. 71102

K. W. KOLBE
2 Rector Street
New York, N.Y. 10006

LYNN R. COLEMAN
2024 First City National Bank Building
Houston, Texas 77002

THOMAS FLETCHER
2025 First City National Bank Building
Houston, Texas 77002
Attorney for United Gas Pipe Line Company

October 20, 1966

FIDELITY PRINTING COMPANY, INC., HOUSTON

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APPENDIX A

Excerpts from the Natural Gas Act, the Internal Revenue Code and Regulations

NATURAL GAS ACT

Section 1(b) The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas. [52 Stat. 821 (1938); 15 U.S.C. § 717 (1946)]

CODE (26 USC 1 et seq):

TAX ON CORPORATIONS

§ 11. Tax imposed

(a) *Corporations in general.* — A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

(b) *Normal tax.* — The normal tax is equal to the following percentage of the taxable income:

(1) 30 percent, in the case of a taxable year beginning before January 1, 1964, and

(2) 22 percent, in the case of a taxable year beginning after December 31, 1963.

(c) *Surtax.* — The surtax is equal to the following percentage of the amount by which the taxable income exceeds the surtax exemption for the taxable year:

(1) 22 percent, in the case of a taxable year beginning before January 1, 1964,

(2) 28 percent, in the case of a taxable year beginning after December 31, 1963, and before January 1, 1965, and

(3) 26 percent, in the case of a taxable year beginning after December 31, 1964 (as amended by 1964 Revenue Act, ~~28~~ 26 USCA § 11, 1966 Supp.)

Sec. 172 [1954 Code]. (a) DEDUCTION ALLOWED. — There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) NET OPERATING LOSS CARRYBACKS AND CARRYOVERS. —

(1) YEARS TO WHICH LOSS MAY BE CARRIED. — A net operating loss for any taxable year ending after December 31, 1957, shall be —

(A) a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss, and

(B) a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

(2) AMOUNT OF CARRYBACKS AND CARRYOVERS. — Except as provided in subsection (i), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the 8 taxable years to which (by reason of subparagraphs (A) and (B) of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other 7 taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable

income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed —

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter,

and the taxable income so computed shall not be considered to be less than zero.

(c) NET OPERATING LOSS DEFINED. — For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

§ 1503. [1954 Code]

* * * * *

(c) REGULATED PUBLIC UTILITY DEFINED. —

(1) IN GENERAL. — For purposes of subsection (b), the term "regulated public utility" means —

(A) A corporation engaged in the furnishing or sale of —

(i) electric energy, gas, water, or sewerage disposal services, or

(ii) transportation (not included in subparagraph (C)) on an intrastate, suburban, municipal,

or interurban electric railroad, on an intrastate, municipal, or suburban trackless trolley system, or on a municipal or suburban bus system, or

(iii) transportation (not included in clause (ii)) by motor vehicle —

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof, or by a foreign country or an agency or instrumentality or political subdivision thereof.

(B) A corporation engaged as a common carrier in the furnishing or sale of transportation of gas by pipeline, if subject to the jurisdiction of the Federal Power Commission.

REGULATIONS — 26 CFR:

§ 1.1502-15. **Liability for tax.** — (a) *Several liability of members of affiliated group.* Except as provided in paragraphs (b) and (c) of this section, the common parent corporation and each subsidiary, a member of the affiliated group during any part of a consolidated return period, shall be severally liable for the tax (including any deficiency in respect thereof) computed as provided in § 1.1502-30, and for any addition to the tax computed as provided in § 1.1502-49 for underpayment of estimated tax for the consolidated return period.

§ 1.1502-30. **Computation of tax.** — (a) *General rule.* In the case of an affiliated group which makes, or is required to make, a consolidated return for any taxable year, the

tax liability of each corporation for the period during such year that it was a member of such group shall be computed, subject to the provisions of paragraph (b) of this section, upon the consolidated taxable income and the consolidated taxable income plus the aggregate of the deductions of the several affiliated corporations allowable under section 242, or, in the case of the taxes imposed by section 531, section 541 (except as provided in paragraph (b)(4) of this section), and section 802, upon the consolidated accumulated taxable income, the consolidated undistributed personal holding company income, the consolidated life insurance company taxable income, the consolidated life insurance company taxable income plus the aggregate of the deductions of the several affiliated corporations allowable under section 242, or the consolidated 1954 life insurance company taxable income, as the case may be, determined in each case in accordance with the regulations under section 1502. In the case of an affiliated group realizing long-term capital gains and computing its tax under the alternative tax provisions of section 1201, the tax shall be computed with reference to the consolidated taxable income, and the excess of the consolidated net long-term capital gain over the consolidated net short-term capital loss. The tax imposed under section 11(c) or section 831 shall be increased for any taxable year for which an affiliated group makes or is required to make a consolidated return by 2 percent of the consolidated taxable income (computed without regard to the deduction, if any, provided in section 242 for partially tax-exempt interest).

§ 1.1502-31. **Basis of tax computation**

In the case of an affiliated group of corporations which makes, or is required to make a consolidated return for any taxable year, and except as otherwise provided in the regulations under section 1502, the tax liability determnied

under § 1.1502-30 shall be determined subject to the definitions and rules of computation set forth in paragraphs (a) and (b) of this section.

(a) *Definitions* — (1) *Consolidated taxable income.* The consolidated taxable income shall be the combined taxable income of the several affiliated corporations:

(i) Minus the sum of:

(a) Any consolidated net operating loss deduction,

(b) Any consolidated section 1231 net loss, relating to net losses from involuntary conversions subject to section 1231, and from sales or exchanges of property subject to section 1231,

(c) Any consolidated charitable contribution deduction, but not in excess of 5 percent of the consolidated taxable income computed without regard to such consolidated charitable contribution deduction, any deductions under part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code, any consolidated net operating loss carrybacks, and any deduction under section 922 (special deduction for Western Hemisphere trade corporations),

(d) Any consolidated dividends received deduction,

(e) Any consolidated section 922 deduction,

(f) Any consolidated section 175 deduction, but not in excess of 25 percent of the consolidated section 175 gross income,

(g) Any consolidated section 247 deduction,

(h) Any consolidated section 582(c) net loss, and

(i) [Reserved]

(j) Any consolidated section 181 deduction,

(ii) Plus any consolidated net capital gain, or

(iii) Minus, in the case of an affiliated group including as members one or more corporations subject to the tax imposed by section 831, the combined additional capital loss deductions of such corporations authorized by section 832 (c) (5) (but in an amount not in excess of the consolidated net capital loss).

§ 1.1502-31(b). *Computations.* In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:

(1) *Taxable income.* The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:

(i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in the regulations under section 1502 as intercompany transactions);

(ii) No net operating loss deduction shall be taken into account;

(iii) No capital gains or losses shall be taken into account;

(iv) There shall be disregarded all gains and losses from involuntary conversions subject to section 1231, and from sales and exchanges of property subject to section 1231;

(v) In the computation of the deduction under section 171, relating to amortizable bond premium, there shall be disregarded the bonds of one member of the

group owned by another member of the group during the taxable year;

(vi) In the computation of the taxable income of a corporation for the taxable year in which it became the common parent corporation of the affiliated group filing a consolidated return, the aggregate deductions of such corporation for such year otherwise allowable in excess of the gross income of such corporation for such year shall be excluded to the extent that such excess is attributable to that portion of such year preceding the date upon which such corporation became the common parent corporation of the group. Any amount excluded under this paragraph shall, to the extent that it constitutes a net operating loss within the provisions of section 172 or a net capital loss within the provisions of section 1222, be considered as a net operating loss or a net capital loss, as the case may be, separately sustained by such corporation and subject to the provisions of paragraph (a) (3) (ii) or (11) (ii) of this section;

(vii) In the case of a corporation which became a member of the affiliated group after January 1, 1954, common parent corporation or subsidiary, as the case may be, allowable deductions shall be determined subject to the qualifications prescribed in subparagraph (9) of this paragraph;

(viii) No deductions under section 170 with respect to charitable or other contributions shall be taken into account;

(ix) In the case of the deduction provided in section 615 (relating to mine exploration expenditures), the allowable deduction shall be determined subject

to the qualifications prescribed in subparagraph (12) of this paragraph;

(x) In the case of a distribution of inventory to which section 311(b) is applicable, or in the case of a distribution of property to which section 311(c) is applicable by one member of the group to another member of the group, the gain recognized under such sections shall be eliminated;

(xi) No deductions under section 243, 244, 245, or 247 (relating to deductions with respect to dividends received and dividends paid) or under section 922 (relating to the special deduction for Western Hemisphere trade corporations), shall be taken into account;

(xii) No deductions under section 175 (relating to soil and water conservation expenditures) shall be taken into account by a member of an affiliated group to which the consolidated section 175 deduction is applicable;

(xiii) In the case of a bank, for taxable years beginning after December 31, 1958, there shall be disregarded all gains and losses from sales and exchanges of property described in section 582(c); and

(xiv) No deduction under section 181 (relating to deduction for certain unused investment credit) shall be taken into account.

Intercompany profits and losses which have been realized by the group through final transactions with persons other than members of the group, and intercompany transactions which do not affect the consolidated taxable income shall not be eliminated. For the purpose of this subparagraph, gain includible in income pursuant to section 357(c) with respect to transfers of assets other than capital assets and

other than assets to which section 1231 is applicable, and gain includible in income by reason of the application of paragraph (a) (1) (iii) of § 1.1502-37, shall not be eliminated. For the purpose of the regulations under section 1502, a transaction not involving a sale or exchange of a capital asset or of property subject to the provisions of section 1231 shall not be considered an intercompany transaction if such transaction occurs in the regular course of the trade or business of the members of the group and if such members adopt, with the consent of the Commissioner and subject to such conditions as he deems proper, a consistent accounting practice of taking into account in the computation of consolidated taxable income the gains and losses reflected in such transactions: As used in this paragraph, the term "taxable income" includes the case in which the allowable deductions of a member (not including any net operating loss deduction) exceed its gross income. For purposes of section 593(b)(2) (relating to addition to reserve for bad debts), taxable income of an organization to which section 593 applies shall be computed as if such organization filed a separate return for the taxable year.

(2) *Other computations on separate basis.* The various other computations required by the regulations under section 1502 to be made by the several affiliated corporations shall be made in the case of each such corporation in the same manner and under the same conditions as if a separate return were to be filed, but with the following exceptions:

(i) *Taxable income.* The taxable income used in any such computation shall be the taxable income of the corporation determined in accordance with the provisions of this section.

(ii) *Dividends received.* In the computation of the dividends received, there shall be excluded all dividends received from other members of the affiliated group.

(iii) *Capital gains and losses.* Capital gains and losses, short-term capital gains and losses, long-term capital gains and losses, and the additional capital loss deduction authorized by section 832(c)(5) shall be determined without regard to:

(*a*) Gains or losses arising in intercompany transactions (other than gains described in section 357(c)) and gains recognized to the distributing corporation pursuant to section 311(c) by reason of distributions by one member of the group to another member of the group,

(*b*) Gains or losses from involuntary conversions and from sales or exchanges of property subject to the provisions of section 1231,

(*c*) The net capital loss carryovers provided in section 1212,

(*d*) In the case of a corporation which became a member of the affiliated group subsequent to January 1, 1954, common parent corporation or subsidiary, as the case may be, capital losses to the extent disallowed pursuant to the provisions of subparagraph (9) of this paragraph, and

(*e*) In the case of a bank, for taxable years beginning after December 31, 1958, gains or losses from sales or exchanges of property described in section 582(c).

(iv) *Net operating loss.* In the computation of the net operating loss, as defined in section 172, the provisions of this section pertaining to the determination of taxable income shall apply.

(v) *Dividends paid.* In the computation of dividends paid, there shall be excluded all dividends paid

by one member of the group to another, except as provided in paragraph (b)(4) of § 1.1502-30.

(vi) *Federal income tax.* In the computation of the Federal income tax, there shall be used the consolidated tax, or a proportionate part thereof, if the tax payable is properly computed on the basis of the consolidated return.

§ 1.1502-34. **Sale of stock; basis for determining gain or loss.** — (a) *Scope of section.* This section prescribes the basis for determining the gain or loss upon any sale or other disposition (hereinafter referred to as "sale") by a corporation which is (or has been) a member of an affiliated group which makes (or has made) a consolidated return for any taxable year, of any share of stock issued by another member of such group (whether issued before or during the period that it was a member of the group and whether issued before, during, or after the taxable year 1929), and held by the selling corporation during any part of a period for which a consolidated return is made or required under the regulations under section 1502. For the basis in the case of a sale of bonds, see § 1.1502-35.

(b) *Sales made while selling corporation is member of affiliated group.* If the sale is made within a period during which the selling corporation is a member of the affiliated group, whether or not during a consolidated return period, and whether or not, as a result of such sale, the issuing corporation ceases to be a member of the group, the basis shall be determined as follows:

(1) The aggregate bases of all shares of stock of the issuing corporation held by each member of the affiliated group (exclusive of the issuing corporation) immediately prior to the sale, shall be determined separately for each

member of the group, and adjusted in accordance with the other provisions of subtitle A of the Code, but without regard to any adjustment under the last sentence of section 1051 relating to losses of the issuing corporation sustained by such corporation after it became a member of the group.

(2) From the combined aggregate bases as determined in subparagraph (1) of this paragraph, there shall be deducted the sum of —

(i) All losses of such issuing corporation sustained during taxable years for which consolidated income tax returns were made or were required (whether the taxable year 1929 or any prior or subsequent taxable year) after such corporation became a member of the affiliated group and prior to the sale of the stock to the extent that such losses could not have been availed of by such corporation as net loss or net operating loss in computing its net income or taxable income, as the case may be, for such taxable years if it had made a separate return for each of such years,

(ii) With respect to each of such taxable years for which consolidated returns were made or were required both for income and for excess profits tax purposes, the excess, if any, of all losses of such issuing corporation for such year, properly adjusted in the computation of consolidated excess profits net income over the amount of such losses for such year computed under subdivision (i) of this subparagraph to the extent that such excess could not have been availed of by such corporation as a net operating loss in computing its excess profits net income for such taxable years if it had made a separate return for each of such years, and

(iii) With respect to each of such taxable years for which consolidated returns were made or were required for excess profits tax purposes only, all losses of such issuing corporation for such year, properly adjusted in the computation of consolidated excess profits net income, to the extent that such losses could not have been availed of by such corporation as a net operating loss in computing its excess profits net income for such taxable years if it had made a separate excess profits tax return for each of such years,

reduced by any losses of the issuing corporation apportioned under this section to its stock sold or otherwise disposed of in a prior transaction, disregarding any transaction between members of the affiliated group during a consolidated income or excess profits tax return period which did not constitute a partial liquidation of the issuing corporation. For any taxable year in which the group sustained a consolidated loss not availed of in prior or subsequent years as a deduction under net loss or net operating loss provisions, the amount deducted under this subparagraph shall be further reduced by an amount equal to that proportion of such consolidated loss which the loss of the issuing corporation for the year in which such loss was sustained bears to the aggregate losses of the members of the group for such year.

(3) The sum of the aggregate bases of all shares of stock, after making the deduction under subparagraph (2) of this paragraph, shall then be apportioned among the members of the affiliated group which hold stock of the issuing corporation, by allocating to each such member that proportion of the sum of the aggregate bases so reduced which the aggregate basis of the stock in the issuing corporation held by such member bears to the sum of the aggregate bases.

(4) The aggregate basis as determined under subparagraph (3) of this paragraph for each member of the affiliated group shall then be equitably apportioned among the several classes of stock of the issuing corporation held by such member according to the circumstances of the case — ordinarily by allocating to each class of such stock that proportion of the aggregate basis which the basis of each class of such stock held by it at the time of the sale is to the sum of the bases of the several classes of such stock held by it.

(5) The basis of each share of stock of each class held by a member of the affiliated group shall then be determined by dividing the basis apportioned to such class under subparagraph (4) of this paragraph by the total number of shares of such class held by it.

• • •

(d) *Definition of "loss", "consolidated loss", "net loss", or "net operating loss", and "consolidated excess profits net income".* As used in this section the term "loss" means either the excess over the gross income of the issuing corporation of the sum of its allowable deductions (not including any net loss or net operating loss deduction) allowable in computing consolidated taxable income or the excess over the gross income of the issuing corporation of the sum of its allowable deductions (not including any net loss or net operating loss deduction), plus the proportionate part properly attributable to such corporation of the credits relating to interest on certain Government obligations and dividends received allowable in computing consolidated normal tax net income, the consolidated special class net income or consolidated net income subject to tax determined in accordance with the Internal Revenue Code of 1939 and provisions of consolidated returns regulations applicable to the period. The term "consolidated loss" means the ex-

cess of the sum of the losses, separately computed, over the sum of the normal tax net income, the special class net income, the net income subject to tax or the taxable income determined in accordance with the provisions of subtitle A of the Internal Revenue Code of 1954, or the Internal Revenue Code of 1939, or the Revenue Act, and pursuant to the provisions of consolidated returns regulations applicable to the period; the term "net loss" or "net operating loss" means the net loss or net operating loss, as the case may be, determined in accordance with the provisions of subtitle A of the Internal Revenue Code of 1954, or the Internal Revenue Code of 1939, or the Revenue Act, and pursuant to the provisions of consolidated returns regulations applicable to the period; and the term "consolidated excess profits net income" means the consolidated excess profits net income or consolidated section 433(a) excess profits net income determined in accordance with the provisions of the Internal Revenue Code of 1939 or the Revenue Act and pursuant to the provisions of consolidated returns regulations applicable to the period.

§ 1.1502-35. **Sale of bonds or other obligations; basis for determining gain or loss.** — In the case of a sale or other disposition by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated income tax or excess profits tax return for any taxable year, of bonds or other obligations issued or incurred by another member of such group (whether or not issued or incurred while it was a member of the group and whether issued or incurred before, during, or after the taxable year 1929) and held by the selling corporation during any part of a period for which a consolidated return is made or required under the regulations under section 1502, the basis of each bond or obligation, for determining the gain or loss upon such sale or other disposition, determined

in accordance with the other provisions of subtitle A of the Code, but without regard to any adjustment under the last sentence of section 1051, shall be decreased (except as otherwise provided in this section) by the excess, if any, of the aggregate of the deductions computed under paragraph (b) (2) or (c) of § 1.1502-34 over the sum of the aggregate bases of the stock of the debtor corporation as computed under paragraph (b) (1) or (c) of § 1.1502-34 as the case may be, held by the members of the group. The adjustment with respect to so much of such deductions as is based upon losses sustained during the taxable year 1929 and subsequent taxable years for which the last day prescribed by law for the filing of the return fell on or before March 1, 1945 (the date on which Treasury Decision 5441 was filed with the Division of the Federal Register), and availed of on consolidated returns filed for such years shall be made only in those cases in which the sales or other disposition of such bonds or other obligations resulted in a loss. See also § 1.1502-40 relating to disallowance of loss upon intercompany bad debts.

APPENDIX B

United Gas Corporation and Subsidiaries
Federal Taxable Income or (Loss), Consolidated and Separate Returned Basis
Years 1957 - 1961 Inclusive

Year		Exhibit 36 Revised Docket No. RP63-1 Rounded	Exhibit 36 Revised Docket No. RP63-1 Dollars & Cents	Eliminations Other Adjustments	Eliminations Dividend Adjustments	Separate Returns Basis Total	Separate Returns Basis United Gas Corporation	Separate Returns Basis United Gas Pipe Line Co	Separate Returns Basis Union Producing Co
1957		Consolidated Basis							
	Taxable Income or (Loss):								
	United Gas Corporation	$74,335,687	$74,335,686		$ 77,088,616				
					(15,559,000) (5)				
					(15,190,930) (6)		$ 19,090,756		
	United Gas Pipe Line Co	$ 61,577,879	$ 61,577,879	$ 65,067,978 (4)	27,200,000 (5)	$ 75,708,258		$ 75,708,258	
	Union Producing Co	(769,975)	(769,974.56)	(2,097,257) (4)		(10,379,899)			(10,379,899)
	Total Taxable Income:								
	Per Exhibit 36 (Revised)	$ 135,143,591	$ 135,143,591.09	$ 62,970,721	$ 63,748,108	$ 65,328,359	$ 19,090,756	$ 75,708,258	$ (10,379,899)
	Per Exhibit No. 14-1, Schedule No. 3, Line 2						$ 19,090,756	$ 75,708,258	$ (10,379,899)
	Explanation of Eliminations:								
			Dividends						
	Notes (1), (2) & (3):	Total Dividends Received	Less Amount out of Earnings & Profits	Balance 100%	85% of 100%				
	Received by United Gas Corporation from:								
	United Gas Pipe Line Co	$ 60,000,000		$ 60,000,000	$ 47,600,000				
	Union Producing Co	134,000,000	$ 34,468,998.85	99,531,001.15	84,601,351.13				
	Total Subsidiary Company	194,000,000	$ 34,468,998.85	$ 159,531,001.15	$ 132,201,351.13				
	Duval Sulphur & Potash Co	93,387,948		93,387,948	79,380,861 (2)				
	Total	$ 287,387,948	$ 34,468,998.85	$ 252,918,949.15	$ 211,582,212.13				
	Received by United Gas Pipe Line Co from Southland Paper Mills Inc	$ 37,000,00		$ 37,000,00	$ 31,450,00 (3)				

Note (2) Capital gains of United Gas Pipe Line Company eliminated on consolidation due to United Gas Corporation's capital loss carryover

Note (5) Capital gains of Union Producing Company eliminated on consolidation due to United Gas Corporation's capital loss carryover

Note (6) Contributions of Union Producing Company on behalf of S% limitation - deductible on consolidation

United Gas Corporation and Subsidiaries
Federal Taxable Income or (Loss), Consolidated and Separate Return Basis
Years 1957-1961 Inclusive

	Year		Exhibit 36 Revised Docket No. RP63-1 Recorded	Eliminations Other Adjustments	Eliminations Dividend Adjustments	Total	Separate Returns Basis United Gas Corporation	United Gas Pipe Line Co.	Union Producing Co.
1	1958		Consolidated Basis						
2		Taxable Income or (Loss):							
3		United Gas Corporation	35,285,221		(86,030,253)(1)		18,993,575.69		
4		United Gas Pipe Line Co.	22,573,974	145,596.96(4)	27,300.00 (2)	22,749,181.37		22,749,181.37	
5		Union Producing Co.	4,554,936	143,766.91(5)		4,996,503.10			4,996,503.10
6		Total Taxable Income:							
7		Per Exhibit 36 (Revised)	30,955,531.	289,363.87	1,549,255.21	46,739,560.16			
8		Per Exhibit No. 141, Schedule							
9		No. 4, Line 4					18,993,575.69	22,749,181.37	4,996,503.10
10									
11		Explanation of Eliminations:							
12									
13			Dividends						
14		Note (1), (2) & (3):	Total Dividends Received	Amount Net of Foreign Tax	Balance 100%	55% of 100%			
15									
16		Received by United Gas Corporation from:							
17									
18		United Gas Pipe Line Co.							
19		Union Producing Co.	17,500,000.00	3,326,975.07	14,479,024.93	12,307,171.19			
20		Total Intercompany	17,500,000.00	3,326,975.07	14,479,024.93	12,307,171.19			
21		Sunset Gulphur & Petrol Co.	1,147,538.62		1,147,538.62	975,407.83			
22		Other Processing Co.	12,500.00		12,500.00	10,625.00			
23		Total Other	1,160,038.62		1,160,038.62	986,032.83			(1)
24		Total	18,660,038.62	3,326,975.07	15,333,760.55	13,293,204.02			
25		Received by United Gas Pipe Line Co. from Southland Royalty Co.	32,000.00		32,000.00	27,200.00			(3)
26									
27		Note (4) Capital gains of United Gas Pipe Line Company eliminated in consolidation due to United Gas Corporation's capital loss carryover.							
28									
29		Note (5) Capital gains of Union Producing Company eliminated in consolidation due to United Gas Corporation's capital loss carryover.							
30									
31									
32									
33									
34									

United Gas Corporation and Subsidiaries
Federal Taxable Income or (Loss), Consolidated and Separate Return Bases
Years 1957-1961 Inclusive

Year		Exhibit 36 Revised Docket No. RP63-1 Recorded	Eliminations Other Adjustments	Eliminations Dividend Adjustments	Total	Separate Return Basis United Gas Corporation	United Gas Pipe Line Co.	Union Producing Co.
1959		Consolidated Basis						
	Taxable Income or (Loss):							
	United Gas Corporation	29395944	4355175(4)	(106196875(1)) 27743886(5)	13989301 60	13989301 60		
	United Gas Pipe Line Co.	20943401 13		2720000 (3)	20970601 13		20970601 13	
	Union Producing Co.	(1856398)	1756397 68	(1794516686)	(18332460 2)			(18332460 2)
	Total Taxable Income:							
	Per Exhibit 36 (Revised)	21944598	1690034	11033658544	33126656 71			
	Per Exhibit No. 14-J, Schedule No. 5, Line 2					13989301 60	20970601 13	(18332460 2)
	Explanation of Eliminations:							
			Dividends					
	Notes (1), (2) + (3):	Total Dividends Received	Less Amount not Out of Balance Earnings 1956	Balance 100%	85% or 100%			
	Received by United Gas Corporation from:							
	United Gas Pipe Line Co.	-						
	Union Producing Co.	18500 0000	5556 1331	7944 3556 69	5451 30369			
	Total Intercompany	18500 0000	5556 1331	9943 3556 69(2)	2451 30369			
	Duval Sulphur & Potash Co.	12187500 00		12187500 00	10357 37500			
	Atlas Processing Co.	306250 00		306250 00	260312 50			
	Total Other	12493750 00		12493750 00	10617 68750 (1)			
	Total	30993750 00	5556 1331	11937 4106 69	13069 99119			
	Received by United Gas Pipe Line Co. from Southland Royalty Co.	320000 00		320000 00	272000 00 (3)			

Note (4) Exclusion from taxable income of dividends, interest income and net investment of United Gas Pipe Line Company in bonds applied in reduction of depreciable property basis.

Notes (5) + (6) Contributions of Union Producing Company in excess of 5% limitation - deductible in consolidation.

United Gas Corporation and Subsidiaries
Federal Taxable Income or (Loss), Consolidated and Separate Returns Basis
Years 1957-1961 Inclusive

Year		Exhibit 36 Revised Docket No. RP63-1 Rounded	Eliminations Other Investments	Eliminations Dividend Adjustments	Total	Separate Returns Basis United Gas Corporation	United Gas Pipe Line Co.	Union Producing Co.
1	1960		Consolidated Basis					
2	Taxable Income or (Loss):							
3	United Gas Corporation	$ 760 979	$ 760 977 891	69 188 150 (1)	$ 1 063 562 60 (1)	$ 924 747 71	$ 1 192 474 771	
4	United Gas Pipe Line Co.	17 569 439	17 569 438 66		8 091 815 50 (3)			
5	Union Producing Co.	(4 333 704)	(4 333 703 86)	96 502 205	27 500 00	17 596 638 66		17 596 638 66
6	Total Taxable Income:					(4 237 623 64)		(4 237 623 64)
7	Per Exhibit 36 (Revised)	15 936 714	15 936 713 71	165 691 837	91 817 806 50	925 376 273		
8	Per Exhibit No. 14-J, Schedule No. 6, Line 2							
9						1 192 474 771	17 596 638 66	(4 237 623 64)
10								
11	Explanations of Eliminations:							
12				Dividends				
13		Total	Base Amount					
14	Notes (1), (2) & (3):	Dividends Received	Not Subject to Earnings Test	Balance	100 %	85% of 100%		
15								
16	Received by United Gas Corporation from:							
17	United Gas Pipe Line Co.							
18	Union Producing Co.	18 500 000 00	10 408 981 85	80 910 195	6 877 365 43			
19	Total Intercompany	18 500 000 00	10 408 981 85	80 910 195 (2)	6 877 365 43			
20	Duval Sulphur & Potash Co.	12 187 500 00		12 187 500 00	10 359 375 00			
21	Other Producing Co.	32 500 00		32 500 00	27 625 00			
22	Total Other	12 251 250 00		12 251 250 00	10 663 562 50 (1)			
23	Total	19 751 250 00	10 408 981 85	93 161 445	7 940 927 93			
24	Received by United Gas Pipe Line Co. from Southland Royalty Co.	32 000 00		32 000 00	27 200 00 (3)			
25								
26	Note (4) Exclusion from Taxable income of 85% of interest income on advancements of United Gas Pipe Line Company's bonds - applicable reduction of depreciable property basis.							
27								
28	Note (5) Contributions of Union Producing Company in excess of 5% limitation - deductible in consolidation.							

United Gas Corporation and Subsidiaries
Federal Taxable Income or (Loss), Consolidated and Separate Return Basis
Years 1957-1961 Inclusive

	Year		Exhibit 36 Revised Docket No. RP61-1 Rounded		Eliminations Other Adjustments	Eliminations Dividend Adjustments	Total	Separate Return Basis United Gas Corporation	United Gas Pipe Line Co.	Union Producing Co.	United Overseas Production Corporation
			Consolidated Basis								
1	1961										
2		Taxable Income or (Loss):									
3		United Gas Corporation	(2,887,741)	(2,887,741.23)	769,117.72 (4)	$ 176,356,750.00	$ 167,517,132.99	$ 167,517,132.99			
4		United Gas Pipe Line Co.	185,583,900	185,583,900.07		27,222,617.08	186,155,900.07		186,155,900.07		
5		Union Producing Co.	(1,602,855)	(1,602,855.05)	934,026.66 (5)		(668,828.39)			(668,828.39)	
6		United Overseas Production Corp.	(243,554)	(243,553.50)			(243,553.50)				(243,553.50)
7		Total Taxable Income:									
8		Per Exhibit 36 (Revised)	155,150,100	155,150,139.07	1,703,144.38	195,907,625.08	352,760,909.17				
9		Per Exhibit No. 141, Schedule									
10		No. 7, Line 4						167,517,132.99	186,155,900.07	(668,828.39)	(243,553.50)
11											
12		Explanation of Eliminations:									
13					Dividends						
14			Total	Less Amount							
15		Notes (1), (2) & (3):	Dividends	Not Out of	Balance						
16			Received	Earnings or Profits	14.29%	85.71% of 102%					
17		Received by United Gas Corporation									
18		from:									
19		United Gas Pipe Line Co.	119,000,000.00		14,001,000.00	119,000,000.00					
20		Union Producing Co.	45,000,000.00		4,500,000.00	38,250,000.00					
21		Total Intercompany	185,000,000.00		18,501,000.00 (2)	157,250,000.00					
22		Duval Sulphur & Potash Co.	12,187,500.00		1,218,750.00	10,359,375.00					
23		Other Processing Co.	325,000.00		32,500.00	276,250.00					
24		Total Other	12,512,500.00		1,251,250.00	10,635,625.00	(1)				
25		Total	197,512,500.00		19,752,250.00	167,885,625.00					
26		Received by United Gas Pipe Line									
27		Co. from Louisiana Paper Mills, Inc.	32,000.00		3,200.00	27,200.00	(3)				
28											
29		Note (4) Exclusion from taxable income of debt retirement income on retirement									
30		of United Gas Pipe Line Company's bonds - applied in reducing									
31		of depreciable property bases.									
32											
33		Note (5) Contributions of Union Producing Company in excess of 5%									
34		limitation - deductible in consolidation.									

APPENDIX C

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Joseph C. Swidler, Chairman; Howard Morgan, L. J. O'Connor, Jr., Charles R. Ross, and Harold C. Woodward.

CITIES SERVICE GAS COMPANY } Docket No. G-18799

OPINION No. 396 — 30 FPC 158.

OPINION AND ORDER DETERMINING TAX ALLOWANCE, DISALLOWING RATES AND REQUIRING REFUND

(Issued July 15, 1963)

ROSS, Commissioner:

This proceeding is before us on the single question of the proper tax allowance to be included in the cost of service of Cities Service Gas Company (Gas Company) and to be reflected in its rates after our approval on March 27, 1961, of a rate settlement agreement between Gas Company and customers representing almost the entire volume of gas sold by it.[1] The settlement cost of service included federal income taxes in the amount of $7,055,981, calculated at the statutory rate of 52 percent upon Gas Company's return after making all deductions applicable to Gas Company as a separate corporate entity but the Settlement Agreement

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[1] This proceeding involves a locked-in period because Gas Company made a further filing increasing its rates in Docket No. RP62-1, which rates became effective on December 23, 1961, except for Rate Schedules I-1 and I-2 which became effective July 23, 1961.

specifically reserved for future determination the issue of the proper amount of federal income taxes to be allowed Gas Company in this proceeding and provided for refunds as a result of a final order on the tax question.

Gas Company is a member of the Cities Service system. The parent corporation is Cities Service Company, which, through its wholly owned subsidiary, Empire Gas and Fuel Company, owns all the outstanding stock of Gas Company and, altogether, directly or indirectly owns the stock of 37 corporations. Among these Gas Company is the only company engaged in the interstate transportation and sale of natural gas. The other subsidiaries are engaged in a wide range of petroleum activities. Subsidiaries explore for and produce oil and natural gas, not only domestically in Oklahoma, Louisiana, Texas, Illinois, Kansas, Mississippi and New Mexico, but also in the offshore areas of the Gulf of Mexico. Other subsidiaries produce petroleum products in Canada, Columbia, Venezuela, Peru, Arabia and the French Sahara. Still other subsidiaries own and operate refineries, oceangoing oil tankers, railroad tank cars, and an office building.

The parent has filed a consolidated tax return for a number of years and Gas Company has been included in the consolidated return except for the years 1950, 1951 and 1952. Under the Internal Revenue Code (Sections 1501-1504) when a consolidated return is filed, all corporations whose stock is owned 80 percent or more by the Parent Company, must be joined in the consolidated return. In the return the losses of any company can be set off against the taxable income of other companies in the group. A net loss in any year can be carried back to the three preceding years or carried forward to the succeeding five years (Sections 172 of the Code). The tax rate on the consolidated

return is 54 percent, instead of the usual 52 percent for a separate corporate income tax return, but the 2 percent penalty applies only to the amount of the consolidated taxable income which exceeds the taxable income that is derived from a utility, such as Gas Company (Section 1503 of the Internal Revenue Code).

The Parent Company has allocated the burden of the consolidated tax payments among the various subsidiaries on the following basis. The regulated companies, such as the Gas Company, were charged 52 percent of their net taxable income while the remainder of the consolidated tax, if any, was then allocated among the nonregulated subsidiaries showing a profit in proportion to their respective taxable incomes. Their intrasystem methods of allocation, of course, cannot be the basis of determining the amount allowable to Gas Company as an operating expense in a rate case.

The staff argues that in computing an allowance for federal income tax to be included in the cost of service the Commission should adhere to its interpretation of the doctrine of actual taxes payable. When any company participates in the filing of a consolidated tax return, it should also participate in any saving generated whichever company is responsible for the saving. The important fact, the staff says, is that Gas Company joins in the Parent Company's consolidated tax returns, so that the taxable income or loss becomes a "fused mass" in which each dollar is indistinguishable from any other dollar. The filing of the consolidated tax return, the staff adds, does not produce any separate income tax liability on the taxable income of the Gas Company, but instead, produces a tax liability for the whole group.

As a result of these views the staff did not apply the statutory rate to Gas Company's taxable income, but rather employed a consolidated effective tax rate of 10.53 percent for the purpose of determining the proper allowance for federal income taxes in Gas Company's cost of service. This tax rate was derived, in essence, by dividing the consolidated tax paid by the Cities Service system by the total taxable income of all the profit making affiliates computed separately for the years 1957, 1958 and 1959.[2] By this method the staff computed an effective tax rate of 23.92 percent for 1957, 0 percent for 1958 (where there was a consolidated tax loss), and 7.67 percent for 1959. It averaged these three figures to obtain its effective tax rate of 10.53 percent which it applied to the Gas Company's income in the test year 1958 to obtain a tax allowance of $785,565.

Cities Service argues that the tax rate actually payable on the Gas Company's stipulated return is 52 percent. It says that taking into account the carry-back of losses, there are no tax savings which can be attributed to the Gas Company's inclusion in the consolidated return. Furthermore, it contends that it is the Gas Company's rates which are in issue here not the rates for the oil, or gasoline, or petrochemicals, or the other products produced and sold by the companies in the Cities Service system. It says that where rates are being set for a utility operation, the costs applicable to that operation are germane, not the costs of the unrelated non-utility operations. It adds that if there is any saving from the non-utility operations they belong to the stockholder who incurred the losses and not to the

[2] Since the test year 1958 showed a consolidated loss, the Staff used the three year period in order to reach a more representative result.

ratepayer, who has paid no obligation of the non-jurisdictional subsidiaries and has not contributed to their losses. The staff's proposal, the companies say, would take away from the investors a portion of the incentive provided by Congress to encourage exploration for oil, domestically and abroad, would put the company at a competitive disadvantage with other oil companies, and would penalize the Parent Company for its form of corporate organization. Cities Service claims that the staff's consolidated effective tax rate is a clear deprivation of property without due process of law, because it takes the benefits of the large tax deductions from the non-jurisdictional companies and passes them along to the gas customers in the form of rate reductions.

In his decision issued April 23, 1962, the Examiner agrees with Cities Service. He holds that the staff's position is basically wrong because it would thwart the true congressional intent of the tax law permitting the filing of a consolidated return, which was to encourage holding companies to expand their overall businesses for the betterment of the national and international economy. He cannot see the justice of permitting Gas Company's customers to receive what he considers a windfall from losses occurring in businesses unrelated to that of the regulated natural gas company merely because Gas Company and the corporations having the losses happen to have a common corporate owner. The Examiner adds that the regulated businesses should not have the right to take away from the non-regulated entity any part of the losses it utilizes for tax purposes. The Examiner thinks that, if driven to it, the Parent Company could rearrange its system of corporations in such manner as to eliminate tax losses, and there would then be no tax saving to allot to the gain companies, including Gas Company. Exceptions were filed by the staff and a

large Municipal Group[3] which had intervened and the issue is before us for decision:

The authorities do not give us a clear answer to the question of whether the tax allowance for the regulated company should take into account the losses of affiliates. Some authorities appear to support the "actual taxes" concept as advanced here by the staff. *City of Pittsburgh* v. *Pennsylvania PUC*, 128 A. 2d 372, 385-387 (Pa. Super. Ct. 1956); Re *New Jersey Power & Light Co.*, 9 N.J. 498, 89 A. 2d 26, 41 (1952). Other authorities eliminate the losses of affiliated companies or of separable operations of the same company. *Southern Union Gas Co.* v. *New Mexico PSC*, No. 31074 (D. Santa Fe County, June 9, 1961); Rates and Rate Structure, 29 PUR (N.S.) 391, 481-482 (N. Y. P.S.C., 1938).

The starting point in resolving the consolidated tax issue is the amount of the consolidated tax payment. This is the only real cost which was incurred by Gas Company in conjunction with the other Cities Service affiliates. The task is then to determine the proportion of the consolidated tax which is reasonably attributable to the Gas Company *vis-a-vis* the other Cities Service affiliates. The basic error in the position of Cities Service is that it ignores this point and claims an amount of Federal income taxes in Gas Company's cost of service on the basis of a hypothetical figure which Gas Company would have paid if it were a separate company. The simple truth of the matter is that Gas Company paid no separate Federal income tax but participated

[3] Consisting of the Kansas Cities of Altamont, Atchison, Chanute, Cherryvale, Downs, Erie, Gerard, Grenola, Howard, Iola, Melvern, Meriden, Osage City, and Perry; the Missouri Cities of Carl Junction, Carrollton, Carthage, Clinton, Independence, Joplin, Kansas City, Marshall, Neosho, Nevada, Oronogo, Pierce, Platte City, Springfield, St. Joseph, Waverly and Webb City; and City Utilities of Springfield, Missouri.

in the filing of a consolidated return with the other Cities Service affiliates. To accept Cities Service's position would be to approve fixing of jurisdictional rates on the basis of converting a hypothetical tax payment into a prudent operating expense. In effect, Cities Service argues that Gas Company ratepayers should make Cities Service stockholders whole for the tax losses of nonregulated enterprises even though this means an allowance for taxes over and beyond that which the consolidated system as a whole actually paid. We reject this view as neither just nor reasonable. Tax allowances in a cost of service are for the purpose of permitting the regulated entity to secure a rate which, after taxes, will provide a reasonable return on jurisdictional investment, not to insure that other components of a complex corporate system are enabled to "cash-in" on their tax losses.

However, we agree with Cities Service that the fundamental rate making principle governing our disposition of this issue requires a separation between regulated and unregulated costs and revenues. This principle controls our allocation of other costs which are jointly incurred by regulated and unregulated companies, or departments within the same company, and is controlling here.[4] If we were to allocate the consolidated system tax return among all profit companies including those in whole or part engaged in unregulated activities, there would be no sound reason for refusing to fix jurisdictional rates at a level sufficient to make up any real losses these companies might suffer.

Staff's approach possesses a quality of artificiality and instability which renders it unsatisfactory for ratemaking purposes. In effect, staff's effective tax rate is derived by

[4] As shown above, this principle is inconsistent with Cities Service's position that Gas Company's tax allowance should be computed as if it were a separate company.

taking the ratio Gas Company's income bears to the total income of the profit making companies, and applying this percentage to the system tax paid. It would be easy for Cities Service to escape from this onerous assessment by rearranging affiliates, mergers or intrasystem pricing arrangements in order to eliminate all or most of the other profit entities and thus increase the effective tax rate of the Gas Company. Significantly, the record shows that Cities Service could accomplish this result.

There are three preliminary matters to resolve before computing Gas Company's tax allowance according to the principles stated above. First, we must decide the period of time to be used in the computation. The Parent Company paid no federal income tax for 1958, the test year. If this test period were representative, we would include no tax allowance in Gas Company's cost of service. However, the tax liability of a complex such as Cities Service for a single year is not apt to be representative. As stated above, the record shows extensive tax data for each of the companies of the Cities Service system for the years 1957 through 1959. While data for a longer period of time might be useful for normalization purposes, in our opinion the detailed data for this three year period of time is sufficient to determine the tax rate applicable to Gas Company.[5]

A second preliminary matter requires us to compute taxable income by normalizing deductions for accelerated amortization and liberalized depreciation, consistent with

[5] We recognize that the record contains limited information for earlier years, i.e., 1954 through 1956. However, the information for the earlier years in this case is not sufficiently detailed to be used in computing the tax allowance for Gas Company in the manner determined appropriate herein; and to the extent that it indicated a different profit and loss picture may have obtained earlier, the subsequent history of Cities Service indicates that such earlier periods could not be considered as representative for rate making purposes.

our treatment in *Alabama-Tennessee Natural Gas Company*, 27 F.P.C. 1180. This is done in Appendix A. However, here as in other rate cases following *Alabama-Tennessee*, the Order herein will be made dependent upon our determination in that proceeding regarding the propriety of normalization for rate making purposes. In the event the so called flow through approach is adopted, the rates herein approved on a tentative basis will be appropriately modified.

The third problem is that there are certain compaines in the Cities Service system a portion of whose business is subject to regulation. The taxable income of these companies should first be allocated into regulated and nonregulated categories. Cities Service, however, has failed to present any evidence upon which to make such an allocation. We can, however, make an appropriate allocation of the taxable income of Cities Service Oil Company, (which represents nearly 99% of the total taxable income of the mixed companies, i.e., those companies having both regulated and nonregulated income), by taking official notice of certain evidence presented in the Oil Company's rate case in Docket No. G-9519, et al. This evidence (taken directly from the Oil Company's own books), shows that 6.28% of Oil Company's gross investment in net plant is devoted to regulated activities (production of natural gas).[6] The data relative to the production of casinghead gas is not included in this figure. Inasmuch as casinghead gas represents 13.51 percent of Oil Company's gas revenues,[7] we will adjust the 6.28 percent figure to take this additional investment into account. Applying the resulting

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[6] Dockets No. G-9510, et al., Exhibit 38, Schedule 3.
[7] IBID, Exhibit 35, Schedule 3, Sheet 3.

7.13 percent[8] to Oil Company's total taxable income of $51,252,182 produces regulated income for Oil Company of $3,654,281.[9] A similar allocation with respect to Cities Service Production Company results in 24.16 percent or $6,464,235 of that Company's tax losses attributable to regulated activities.[10]

Having made these adjustments, we can now allocate the tax cost of the Cities Service system between regulated and nonregulated companies. For the three year period under consideration, the nonregulated affiliates, including nonregulated income of Oil Company, had no taxable income. In fact, the record shows they had a substantial tax loss. It is therefore inappropriate to assign any tax liability to this group of companies. Accordingly, we conclude that the actual tax paid by the Cities Service system, as normalized, is reasonably allocable among the regulated companies.

In sum, the proper method to be applied in computing the Federal income taxes to be included in the cost of service of a regulated company where that company has joined in a consolidated tax return with affiliates is (1) separate the companies into regulated and unregulated groups, (2)

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[8] This figure was obtained by multiplying $29,775,181 (investment in gas plant excluding casinghead) by 1.1351. The resulting figure of $33,797,808 is divided by total plant investment of $473,788,545 which produces 7.13%.

[9] We wish to make it clear that a simple manner of allocating the taxable income of mixed companies should be used in any future cases involving this issue. Obviously, it is administratively infeasible to compute a detailed cost of service for large integrated corporations to determine one element of a regulated company's cost of service.

[10] $12,970,608 or 17.46 percent of Production Company's average net investment of $14,276,476 relates to gas production, exclusive of casinghead gas. Casinghead gas represents 38.34 percent of the Company's gas revenues, and the 17.46 percent figure adjusted to take this further investment into account produces 24.16 percent. (Docket No. G-9510, Exhibit 32, Schedule 2, Sheet 1, and Exhibit 35, Schedule 2, Sheet 2).

determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate making purposes, if computed on a separate return basis.

The computation of Gas Company's tax allowance is computed in Appendix B. As this Appendix shows, we based this computation on the ratio Gas Company's taxable income bears to the total taxable income of the regulated group. This, of course, is similar to staff's approach which we consider reasonable when the nonregulated affiliates have been excluded.

The Commission further finds:

(1) Gas Company's proper tax allowance is $5,866,847.

(2) The rates filed by Gas Company filed pursuant to the Settlement Agreement and our order of March 27, 1961, subject to the reservation of the tax issue are excessive and should be disallowed.

(3) Gas Company should file tariff sheets and make refunds in accordance with this opinion.

The Commission orders:

(A) The rates filed by Gas Company pursuant to the Settlement Agreement and our order of March 27, 1961, are hereby disallowed.

(B) Gas Company shall, within 45 days of the date of this order, file appropriate substitute tariff sheets to its FPC Gas Tariffs except for Rate Schedules I-1 and I-2 containing rates satisfactory to the Commission based on

a tax allowance of $5,866,847 for the test year, found to be appropriate in this opinion and order. Gas Company shall accompany its rate filing with supporting cost of service and allocation data persented in the same form and manner as that contained in the exhibits attached to the stipulation approved in our order of March 27, 1961, revised only to reflect the change in the allowance for federal income taxes. Gas Company shall further furnish with its filing a statement setting forth the method of computation of such rates and showing the derivation thereof. Gas Company shall also accompany its tariff sheets and supporting data with a certificate showing service of copies thereof on all purchasers under the rate schedules involved, interveners in this proceeding, and interested state commissions. Comments by such parties shall be submitted to the Commission within ten days after service by Gas Company as required herein.

(C) Upon acceptance by the Commission of the tariff sheets filed by Gas Company pursuant to paragraph (B) above, the rates, charges and classifications set forth therein shall become effective for the period November 23, 1959, through December 22, 1961.

(D) Gas Company shall, within 70 days of the date of this order, file with the Commission a statement showing the distribution to its jurisdictional customers of appropriate amounts to be refunded with interest at 6 percent. With respect to Rate Schedules F-1, F-2, C-1, C-2, E, P and X-5 the refund shall represent the differences between (1) the amounts collected under rates charged in accordance with the stipulation of October 21, 1960, and our order of March 27, 1961, and (2) the amounts that would have been collected under the rates filed pursuant to this opinion and order, from November 23, 1959, to December 22, 1961, with interest at 6 percent. With respect to Rate

Schedules I-1 and I-2 the refund shall, in accordance with the stipulation, represent an amount equal to 50 percent of the difference between (1) the sum that would have been payable under I-1 and I-2 Rate Schedules made effective February 23, 1961, for natural gas purchased from Gas Company during the period from June 23, 1959, through July 22, 1961, and (2) the charges which would have been payable for such service during the same period if I-1 and I-2 rates reflecting the Commission's determination of the reserved tax issue had been in effect.

(E) Gas Company shall accompany its statement of refunds with a computation of the refunds and interest, and the derivation thereof, and with a certificate showing service of copies thereof on all purchasers under the rate schedules involved, interveners in this proceeding, and interested state commissions. Comments by such parties shall be submitted to the Commission within ten days after service by Gas Company as required herein.

(F) Within 10 days of the approval of the statements of refunds by the Commission, Gas Company shall make the required refunds so computed and within 15 days thereafter shall report to the Commission in writing and under oath the amount of refund made to each of its customers, showing separately the amount of principal and interest so paid and shall serve a copy of such report upon each of the customers receiving a refund. Concurrently therewith, Gas Company shall file with respect to such refunds, releases from its jurisdictional customers showing receipt of the principal and interest in conformity with this opinion and order.

(G) As provided in the Settlement Agreement approved by our order of March 27, 1961, Gas Company shall file further rate reductions and make further refunds as a result

of refunds to it by its suppliers or a reduction in its cost of purchased gas.

(H) The rates required to be filed herein are specifically subject to such further adjustment as may be required as a result of the application of a final decision by the Commission in *Alabama-Tennessee Natural Gas Co.*, Docket No. G-5471, *et al.*,* on the treatment of deferred federal income taxes to the computation of the tax allowance made herein but only from and after the date of such decision or a later date if specified by the Commission therein.

(I) Exceptions not granted herein are hereby denied.

Commissioner Morgan *concurring*, filed a separate statement appended hereto.

Commissioner Woodward *dissenting*, joined by Commissioner O'Connor, filed a separate statement appended hereto.

/s/ J. H. Gutride
Joseph H. Gutride,
Secretary.

* [Issued February 2, 1964, 31 FPC 208]

Docket No. G-18799 **Appendix A**

CITIES SERVICE GAS COMPANY

Normalization of Cities Service Consolidated Tax

Particulars	Calendar Year 1957	1958	1959	Total
(1)	(2)	(3)	(4)	(5)
Calculation of Tax on Consolidated Basis Using Straight Line Depreciation				
Consolidated Taxable Income (Form 1120)	$23,637,088	($7,145,571)	$ 7,003,440	$23,494,957
Add: Excess of liberalized depreciation and accelerated amortization over straight line	9,147,913	10,245,432	9,153,089	28,546,434
Subtotal	32,785,001	3,099,861	16,156,529	52,041,391
Deduct: Long-term gain	(808,323)	(2,248,731)	(2,486,203)	(5,543,257)
Income subject to 54%	(18,073,798)	—	—	(18,073,798)
Balance taxable at 52%	13,902,880	851,130	13,670,326	28,424,336
52% of utility income normalized	7,229,498	442,588	7,108,570	14,780,656
54% of non utility income normalized	9,759,851	—	—	9,759,851
25% of capital gains	202,081	562,183	621,551	1,385,815
Total	17,191,430	1,004,771	7,730,121	25,926,322
Less surtax exemption	5,500	5,500	5,500	16,500
Tax assuming straight line depreciation	$17,185,930	$ 999,271	$ 7,724,621	$25,909,822

Docket No. G-18799 Appendix B

CITIES SERVICE GAS COMPANY
COMPUTATION OF GAS COMPANY F.I.T.

Income (Normalized)	1957	1958	1959	Total
Cities Service Gas Company	$11,280,832	$12,256,412	$18,340,470	$41,877,714
Cities Service Gas Producing	2,158,402	2,085,416	2,183,609	6,427,427
Cities Service Pipe Line Co.	2,622,047	2,686,669	3,093,433	8,302,149
Lafitte Oil Traders, Inc.	22,562	125,455	275,155	423,172
Kansas Gas Supply Company	215,128	339,359	313,433	867,919
Cities Service Oil Co. — Del. (Regulated Portion)	1,499,006	1,259,798	895,477	3,654,281
				61,652,662
% of Cities Service Gas Co. to Total regulated companies*				67.93%
Consolidated Tax Allowance for Years 1957-1959 (Appendix A)				25,909,822
Average Consolidated Tax Allowance ($25,909,822 ÷ 3 years)				8,636,607
Tax Allowance for Cities Service Gas Co. (67.93% x $8,636,607)				$ 5,866,847

* No portion of the consolidated tax is allowable to Cities Service Production Company because that Company had no taxable income.

MORGAN, Commissioner, *concurring:*

On the basis of the record before us it appears that, by virtue of filing a consolidated Federal income tax return for the years 1957 through 1959, the Cities Service System companies collectively enjoyed a Federal income tax saving in the order of some $48 million.

It also appears from the record before us that with few exceptions, one of which is discussed below, the parent company allocated this enormous saving among the mem-

bers of its corporate family on the proportionate basis of the taxable income each of them produced. This appears eminently fair, and this, moreover, is the method the tax regulations suggest for distributing these savings among the corporate family.

It is the "few exceptions" that concern us — most particularly, the Cities Service Gas Company. We are concerned with this "exception," first because that company sells a commodity vested with a public interest, at rates having the force of law, to consumers whose ratepaying welfare we are charged by Congress with protecting; second, because on the basis of allocating this saving which parent has chosen for its *unregulated* companies (that is, in proportion to taxable income), this particular public utility *should have* enjoyed savings of about $17.7 million during the period mentioned; third, because utility regulation traditionally and without detectable exception has always required savings in utility tax costs to flow through in the form of reduced rates to the consumers who alone and by law must bear the utility's entire tax burden; and fourth, because the parent in this case has refused to apportion, distribute, allocate or grant a single penny of the entire tax saving to the public utility that has been placed under what should be the watchful eye of the Federal Power Commission.

The vociferous legalisms and cries of outrage that the company has raised as a result of staff's suggestion that this utility, like its sister affiliates, should share fairly, equitably, and proportionately in the tax saving in question — a tax saving made possible in large part by the utility's taxable income — have created a large and to some degree confusing record here.

But the company's cries of outrage are no more heartfelt than the cries and suggestions of "outrage," "fraud,"

"fictitious," "dishonest," "indefensible," "sinful" and other expletives that were uttered in the United States Senate and House of Representatives when, despite the same defenses offered there as here, the details of the selfsame practices by the selfsame company were made known to the Congress during its consideration of the bill that became the Public Utility Holding Company Act of 1935.[1]

The practice was not then and there outlawed because — and it is safe to say *only* because — that very practice had been forbidden for any and all corporations, except

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[1] Specifically, see pages 477-482 of Volume 72A, "Utility Corporations," setting forth the results of certain financial practices uncovered in the course of the Federal Trade Commission's massive investigation in this utility area from 1928 to 1935; see the hearings on the bill before the House Commerce Committee at pages 153-155; Senate hearings at pages 234-255 and 514; the debate on the bill in the Senate at 79 Cong. Rec. 8392 and 8525-26; and in the House at 10323.

The comment of Senator Norris was typical:

> "Practically all the systems I have shown on the various charts, together with others not shown, made what the law formerly permitted — that is, returns for taxation purposes on a consolidated basis — resulting in a great saving of taxes to the holding-company groups, although, as a matter of fact, operating groups as a rule were subject to a tax. However, the holding companies, taking advantage of the law permitting consolidated returns, collected the taxes from their operating companies, and then, by setting off losses sustained by some of the operating companies, it was possible in this way to retain these taxes by balancing losses of some operating companies against profits of other operating companies. Thus it has often happened that operating companies have paid taxes which ordinarily would have been due the Federal Government, and the holding companies by balancing off losses from other operating companies paid no tax to the Federal Government, but retained the money the operating company had paid as taxes. So some operating companies actually paid their taxes, expecting the money to go to the Federal Government through the holding companies, but by the process I have just described the holding companies kept the taxes and paid nothing to the Federal Government. If anybody can square that with honesty, I should like to have him do it."

railroads owning 95% of their operating subsidiaries, by the Revenue Act of 1934. But, with the imposition of the wartime excess profits tax, Congress by the Revenue Act of 1942 allowed the practice to be resumed. The matter is now before us, a Federal public utility commission, for disposition in the light of the basic tenets of the public utility law we are charged with administering.

If this were a matter of tax law, as company and the dissenting opinion would have us treat it, we, like the Internal Revenue Service, would only be interested in checking the accuracy of company's arithmetic. But this is a rate proceeding, not a tax audit. The problem here is only the problem of determining how the utility's share of the system's actual tax liability should be determined; or the extent to which a regulated utility's tax and rate-paying consumers should realize or be deprived of a saving in tax charges which in utility law are imposed upon and chargeable exclusively to utility ratepayers.[2]

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[2] Consolidating the income of several wholly-owned corporations for the purpose of determining system income is especially appropriate in the case of public utillity systems, because management often chooses to organize those systems into a series of separate corporations to facilitate doing business in each of the states in which the utility system operates. This is the reason used to justify the use of the consolidated return by utilities before Congress; and this also is the reason Congress removed the 2% penalty tax for public utilities that file consolidated returns (see House Ways and Means and Senate Finance Committee hearings on H. R. 8400 in the 84th Congress, the bill that became the Internal Revenue Code of 1954). And in removing that penalty tax, as well as in making the privilege of filing consolidated returns available to public utilities as well as to other taxpayers, Congress was aware that from the time of the Supreme Court's opinion in the Galveston case, 258 U.S. 388, (1922) if not earlier, where the law of public utility regulation operates it requires utility consumers to pay the full amount, but not more than the full amount, of the utility's actual tax liability, or its allocated share of the system's actual tax liability.

The difficulty is not in determining whether this utility's share of the tax saving should benefit the consumers who pay its taxes: the difficulty is in estimating this utility's proper share of the saving. Many methods for allocating that saving or estimating the utility's share thereof have been explored, but each has been found wanting by my colleagues. Speaking for myself, I must say that the method used by Cities Service for allocating its total tax liability and tax saving among *some* of its subsidiaries, and by the staff for allocating that total liability and saving among *all* of Cities Services' subsidiaries, is the most logical method and the one which best meets the standards and requirements of utility regulation. Further, it alone of all methods considered here is the one which reflects those vigorous expressions of Congressional intent in this particular matter which should guide the exercise of our discretion.

Briefly, the facts in this case relating to the three-year period under review are these: The system of which Gas company is a part consists of 37 separate corporations, about 6 of which are regulated; and the tax losses of some of the system's companies reduce the taxable profits of its regulated and unregulated companies and thereby reduce the system's over-all actual tax liability. The amount of the system's actual liability — or its tax saving (i.e., the difference between the total tax that would have been paid if each company in the system had been taxed separately, and the tax actually paid on the profits of those companies as reduced by the losses of the other companies) — properly should be distributed or apportioned over the system's profit companies on the basis of the separate taxable income each profit company had; and the record before us is totally barren of any sensible reason for differentiating between regulated and unregulated companies. At least it is barren of any reason which will stand scrutiny in the light of the public interest.

Here the total profits of the system's profit companies for the three year period were $123.4 million; other system companies had tax losses totalling $100 million; taxable system income thus was $23.4 million; and consolidated system tax liability for the three-year period was $11.4 million. The tax saving thus realized was the difference between the $63.2 million that the profit-making companies would have paid if they had been taxed separately, and the $11.4 million that the system actually paid, or (excluding a $4 million refund in 1958 of 1955 taxes) roughly $48 million.

Taxable profits of Gas company alone were $42 million; and it would have paid a tax of about $22 million *if* it had been taxed separately.

If the system's over-all tax liability or tax saving had been distributed among the profit companies proportionately on the basis of their separate taxable incomes, since Gas company's $42 million of taxable income was about 35% of total system taxable income ($123.4 million), Gas company should bear about 35% (or $4 million) of the system's actual $11.4 million tax liability; and should benefit by about 35% (or $17 million) of the system's $48 million tax saving.

But Gas company did not charge its consumers $4 million for taxes. It charged them the $22 million Gas company would have had to pay *if* it had been taxed separately. Gas company turned over the $17 million saving to the parent company, which, the record shows, used these funds to subsidize its non-regulated activities.[3]

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[3] We are only concerned with Gas company's $17 million share of the system's $48 million tax saving, because that $17 million was actually paid in cash by Gas company's consumers who pay its "taxes." We are not concerned with the other $31 million. To the extent it is attributable to the system's unregulated companies, it belongs to the stockholders and management who must see that the taxes of those companies are paid.

Gas company says this is all right. It says it really did have a "tax" bill of $22 million, because the parent company on its books did not allocate any of the system's $48 million tax saving to Gas Company. The parent company purposefully assumed that its tax losses wiped out the taxable income of its unregulated companies (only), and that the whole 37-company system's tax liability was chargeable to the regulated companies alone. The result of this "allocation theory" — to use a very dignified term — is that Gas company's consumers were charged an amount for "taxes" that was larger than the actual tax liability of the entire 37-company system.[4] Moreover, Gas company did not reduce its "tax" charge to its consumers even in years when the amount of system tax loss was so large that, after wiping out all unregulated company profits, it *should have* reduced Gas company's separately computed "tax" charge. The parent company did not give Gas company's consumers the benefit of Gas company's share of the tax savings as computed, *even under its own arbitrary allocation method.* The position of Cities Service company is that none of the system's tax savings should be used to reduce Gas company's hypothetical "tax" charges to its consumers, because those consumers did not finance the tax losses that gave rise to those savings. But, as we shall see, that is exactly what the consumers did, although involuntarily.

This entire practice is in complete conflict with the established principle that because a utility's consumers alone must pay its entire tax bill under rates having the force of law, a utility cannot charge its consumers more for taxes than the actual amount, estimated where necessary, that the utility actually paid or contributed to the U.S. Treasury,

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[4] During the three-year period in question, although total system actual tax liability was (only) $11.4 million, Gas company's consumers were charged $22 million for "taxes."

or more than the utility's *proper and equitable share* of the system tax actually paid. In the utility field, stockholders are entitled to a fair, constitutional rate of return, and the tax thereon is paid by utility consumers so that the fair return will not be reduced by taxes. Once the utility or its stockholders have received that return, they may not obtain more by claiming higher, fictitious, or hypothetical costs they might have incurred if they had been organized or operated in some other, *unreal* manner. To allow additional return — over and above a fair return as defined by the courts — is to countenance unjust enrichment of the utility or its owners at the expense of the ratepayer.

My colleagues, perhaps unwilling to chart clear regulatory policy amid the consolidated tax legalisms raised herein, prefer (a) to separate the system's business into its regulated and unregulated portions; (b) to apply all of the system's tax losses (which normally stem from some of its unregulated activities) to reduce the profits or tax liability of its unregulated profit companies first, and then (c) to use whatever loss deductions may remain to reduce the liability that the utility or utilities would have had if they were separately taxed. This, it will be noted, gives the priority of use of the system's tax loss benefits primarily or even entirely to its unregulated profit companies.[5]

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[5] On the basis of Gas company's average "tax" charged during the three-year test period used herein, Gas company here claimed an average annual "tax" allowance of $7,055,981; on the basis of an allocation of the system's average actual tax during that period, staff claimed, properly, in my opinion, that Gas company should receive a tax allowance of $789,082; the majority opinion herein (after normalizing tax deductions for liberalized depreciation and accelerated amortization and making other refinements) grants Gas company $5,866,847. This is not regulation at its best. My reasons for accepting this result are set forth hereinafter.

In passing, it may be noted that if this policy is equitable and if "turn about is fair play," the priority could and perhaps should be reversed for regulatory purposes. That is, if preference is to be given either group of subsidiaries, regulatory authority might properly apply the tax loss benefits first to wipe out the tax liability of the *regulated* subsidiaries (which almost invariably operate at a taxable profit), and then to use whatever loss deductions may remain to reduce the tax liability that the *unregulated* subsidiaries would have had if their taxes had been separately computed. This would not alter the system's overall tax liability. But it would produce significantly larger tax reductions for the regulated companies, which would eventually be translated by regulatory authority into reduced rates and gross revenues. It would likewise greatly reduce the expendable funds, generated in the guise of "taxes" paid by utility ratepayers, which the parent company now disburses across the face of the earth to operate the speculative ventures of its various non-regulated corporations.[6] It is these specific corporate operations, *in large part financed and underwritten by "taxes" extracted from ratepayers,* which give rise to the tax loss benefits which the parent company claims it has the *exclusive* right to enjoy on the ground that the ratepayers had nothing to do with them!

It naturally follows that reversal of the priorities herein approved would produce another barrage of legalisms and redoubled screams of rage and pain from the parent company. The reader, whether he is a judge, a corporate lawyer or a utility ratepayer, can reach his own conclusions as

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[6] That the great bulk of these far-flung speculative enterprises are of no benefit or advantage to consumers who are served by Gas company — and who pay its "taxes" — is made abundantly clear by the majority opinion in the second paragraph thereof.

to the validity of such protests. For if he has followed the discussion this far he can see clearly what has been happening and he knows exactly to whom it has been happening.

In any event, it is clear that the policy adopted here gives priority and favored treatment to the non-regulated companies rather than to those whose rates are subject to regulatory control by this and other commissions. I should have preferred that no priority or favored treatment be given to either group; and, speaking only for myself, I therefore believe that the actual tax and actual tax allocation method here urged by the staff is the preferred solution to this problem.

Most reluctantly, however, and solely for the purpose of enabling a decision to be reached in this case, I concur in the policy adopted by my colleagues of the majority. Though far from perfect, it is a discernible improvement over the situation that has existed here and in numerous other corporate families for many years. The approach of the majority, which is more in the nature of an assignment than an allocation, will serve at least to limit the tax liability of Gas company's ratepayers to the actual liability of the entire system as a whole. It at least will prevent them from having to pay a tax charge that is *larger* than the actual liability of the entire system of which Gas company is a minor part.[7] This is no small matter, for Gas company's lawyers have been unable to obscure the fact that in 1958, when the tax liability of the total system was zero, the parent company nevertheless imposed a "tax" charge upon the ratepayers of the regulated utility in the amount of $6,367,534, not one penny of which was paid to the Federal Treasury.

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[7] Gas company's jurisdictional revenues represent about 5% of the system's gross revenues.

In sum, this method of apportioning the tax saving and tax burden has the limited virtue of accommodating, to a very small and unsatisfactory degree, the two irreconcilable concepts at war with one another here. That is, it permits company and stockholder to enjoy an overly generous portion of the benefits which they erroneously claim are entirely theirs by virtue of the tax law alone; and it goes some small way toward producing a more equitable charge to ratepayers for the estimated amount of tax liability actually incurred by or attributable to the regulated utility that serves them.

I should have preferred that we face our responsibilities squarely and discharge them fully. Regrettably, that is not possible; and without my concurrence the little that has been accomplished herein will be lost. It is only on that account that I concur in the result reached by my colleagues of the majority.

/s/ HOWARD MORGAN, Commissioner
Howard Morgan, Commissioner

WOODWARD, Commissioner, joined by
O'CONNOR, JR., Commissioner, *dissenting*:

This is a major rate case in which the Commission must decide a fundamental and critical question. While the Commission, in the past, has properly insisted that certain tax advantages to be obtained from filing a consolidated return for groups composed entirely, or predominantly, of regulated companies, be passed on to consumers, it has not held that business losses of unregulated and unrelated corporations participating in a consolidated return should be uti-

lized for the benefit of the consumers of a regulated natural gas company. The latter issue is before us for the first time.

The majority concludes that the proper method to be applied in computing the Federal income taxes to be included in the cost of service of a regulated company where that company has joined in a consolidated tax return with affiliates is (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group on the basis of their respective taxable incomes. If each of the resulting groups shows a net taxable income, this formula would fairly allocate the total tax in accordance with the respective amounts of taxable income. But where, as here, the unregulated group has a net loss for the test period, the formula appropriates that loss which was the result of expenses and losses financed by the stockholders and deducts it from the tax allowance to be charged the ratepayers, thereby granting to them the entire benefit emanating from the tax loss. As applied here, the $2.4 million net taxable loss of the unregulated group is handed over to the ratepayers by deducting it from the taxable income of Gas Company, thereby reducing its tax allowance by $1.2 million.

The Opinion and Order adopted by the majority is based on the false premise that, as to industries regulated by it, the Commission has the authority to limit the effect of a mandate of Congress as expressed in Section 1501 of the Internal Revenue Code. Depriving Gas Company of a tax allowance which would be routinely granted to it by the Commission if it were not for its having a common owner with an unregulated and unrelated petroleum business, should not be done without some very persuasive reasons

based upon sound rate-making policies which impose no confiscatory rates, which balance equitably consumer and investor interests and which take fully into consideration the impact of such action upon national economic policies. At the root of regulation is economic policy. The problem of economic growth in the United States is crucially important and inseparably related to economic growth is investment. Under the majority view, the consolidated return would not result in stimulating investment and growth because it has the effect of converting non-jurisdictional losses within the parent company's system into a rate reduction for gas consumers. The majority opinion is not supported by persuasive reasons based on sound policy.

Since this Commission possesses only the legislative powers which the Congress has granted to us, clearly we have no power to amend Section 1501 of the Code. Apart from the fact that there are no tax savings attributable to the inclusion of Gas Company in the consolidated return, the majority view is unlawful because it has the effect of regulating non-utility enterprises beyond the Commission's jurisdiction; it would strip the parent company of congressionally-conferred rights to tax deductions of its non-jurisdictional subsidiaries. The Majority is in error and I dissent.

The Cities Service system is operated principally as an integrated petroleum operation. The jurisdictional revenues of Cities Service Gas Company, a wholly owned subsidiary of Cities Service Company, comprised approximately 4.88%, 5.14% and 6.16% of the total system revenues in 1957, 1958, and 1959 respectively. Only 3% of the gross revenues of two other companies in the system are subject to Commission jurisdiction.[1]

[1] Cities Service Production Company and Cities Service Oil Company (Delaware).

In this proceeding, the Commission is to determine the proper Federal income tax allowance to be included in the cost of service of Gas Company, one of 37 subsidiaries joining the parent company in the filing of a consolidated return.[2]

Chapter 6 of the Internal Revenue Code, "Consolidated Returns," Section 1501, "Privilege to File Consolidated Returns" gives to "an affiliated group of corporations the privilege of making a consolidated return with respect to the income tax imposed" on corporations of which the parent company owns 80% or more of the outstanding stock. When corporations join in such returns, the Code, Section 1503, levies an additional 2% tax upon all includable taxable income except that of utilities such as Gas Company whose tax rate remains at the statutory rate of 52%.

The precise intent of Congress in granting the privilege of the consolidated return to an affiliated group of corporations was to encourage companies to expand their overall businesses for the betterment of the national and international economy and to eliminate any tax disadvantages of doing such through subsidiaries.

The parent company here owns, directly or indirectly, 100% of the stock of every corporation which participates

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[2] Consolidated returns are based on the principle of levying a tax on the true income of a single enterprise even though the business is operated through more than one corporation.

The primary advantages of filing a consolidated return may be summarized as follows:

(1) The offsetting of operating losses of one company against the profits of another.

(2) The consummation of inter-company transactions without the recognition of income.

(3) The designation of the parent company as agent of the group for all tax purposes.

in the filing of its consolidated return. As such stockholder its own 100% of the assets of each corporation, and it is entitled to 100% of all net income of each, subject to income tax levies. Also, as the sole stockholder, it bears 100% of every risk, expense and loss sustained by its subsidiaries. These expenses and losses should not be appropriated for the consumers of a regulated natural gas company who bore no part of them, assumed no risks in relation to them, and have no right to use them to reduce their gas costs.

The parent's conducting of its petroleum business through many subsidiaries is a matter of lawful choice and the permission given by the Internal Revenue Code for the filing of one consolidated return by qualified affiliated subsidiaries recognizes such lawfulness. Gas Company performs no activity or function in relation to the parent company's primary business of conducting its petroleum operations. Gas Company is a regulated natural gas company transporting and selling natural gas for resale in interstate commerce and it is operated as such entirely separately from the petroleum operations of the parent company. *Whether one of the included corporations has a taxable gain or loss is determined from its individual tax return calculated separately. It is in the separate return where all lawful expenses of operation are deducted to determine whether there is income of the individual corporation subject to tax.* (emphasis supplied)*

The examiner clearly determined, on the basis of record, that no part of the cost of producing the revenues of the petroleum business contributes in any way to produce Gas Company's revenues. No part of Gas Company's costs, including its income tax allowance, contrib-

* [I.e., by Commissioner Woodward.]

utes in any way to producing revenues to the petroleum entity. No part of any loss of any subsidiary corporation in the petroleum business, operated as an entity, is reflected in Gas Company's agreed cost of service. The net taxable income of Gas Company gave rise to no tax savings by the parent; the parent, in effect, see p. 174 [32-3c] *infra*, paid the full 52% statutory rate on the taxable income of the Gas Company.

I see no justification for crediting the Gas Company with part of the losses, thereby reducing its allowance for income taxes. To do so would result in a windfall to the Gas Company's customers and would deprive the parent of tax deductions to which it is lawfully entitled. Stated simply, the tax savings were the result of non-jurisdictional operations and were not financed by Gas Company nor in any way made possible by the inclusion of the Gas Company in the consolidated tax return group. Most assuredly, Gas Company is not entitled to tax savings arising out of foreign and domestic exploration, production, refineries, gas station operations, petrochemical, tanker and other non-jurisdictional operations. The majority view would inflict harmful consequences on the unregulated subsidiaries which the Commission is without power to cure. Unlike the case when it regulates the Gas Company alone, the Commission lacks authority either to increase or decrease the prices which the non-utility subsidiaries charge for their petroleum products. Briefly, the majority proposal is a regulatory one way street.

As Examiner Kelly has correctly declared, "The Code does not contain the criteria for rate making in this case. Under the Code, one only considers whether the corporations involved are qualified to participate in the consolidated return, whether such qualified corporations have lawfully computed their respective tax labilities, what the con-

solidated tax should be, and whether all other tax laws or regulations have been met . . . The Commission determines the proper return to be allowed upon the rate base and the proper income tax allowance to make the return net to the investor, and no tax law or regulations should interfere with the performance of this function by the Commission . . . The Commission has the full right to examine all figures in such consolidated tax return, and to ascertain from what situations or circumstances they may have resulted. There considerations are demanded by the public interest. The public interest demands that a petroleum business receive, at the hands of the Commission, at least as much encouragement and incentive in the conduct of its exploration and development activities as the national policy particularly as expressed in the income tax laws, dictates."

The uncontroverted evidence of record conclusively establishes that for each of the test years selected, the inclusion of Gas Company added a cost to the consolidated return in an amount equal to 52% of Gas Company's taxable income. In 1957, the parent company paid a consolidated tax of $12,251,639 on the income of its subsidiaries of which $5,860,398 was attributable to and equal to 52% of Gas Company's taxable income. In 1958 the parent company received a tax refund of $6,367,534, but it would have received a total refund of $10,224,666 if Gas Company had not participated in the consolidated return. Thus, the parent company, in effect, paid a tax of $6,367,534, representing 52% of Gas Company's 1958 taxable income, by foregoing the additional refund in that amount. In 1959, the parent company paid a tax of $2,965,014, but it would have received a refund in the amount of $6,566,531, if Gas Company had not been included in the consolidated return. Thus, the parent, in effect, paid $9,531,545 in payment of the tax at the rate of 52% on Gas Company's taxable income. The record shows that Gas Company's taxable income was not necessary to produce tax savings in the test years.

There is no question that Gas Company would pay a 52% tax had it been considered on a separate basis. The parent, by including Gas Company in the consolidated return, added a cost thereto equal to 52% and allocated a 52% cost to the Gas Company. I fail to see where the inequity of such an allocation lies. The parent company obtains no tax or other advantage from including Gas Company in its consolidated return. Owning 100% of the stock of Gas Company, the law requires that it includes this subsidiary in its consolidated return. Gas Company, being a regulated monopoly with a practically assured net income each year, is not among the subsidiaries with losses to offset against the total net taxable income of all subsidiaries having such losses. Therefore, no tax saving whatever results to the parent company from the inclusion of Gas Company in the consolidated return.

The examiner noted further, "Any immediate but perhaps temporary tax saving accomplished by the filing of a consolidated return is not in any sense comparable to a real and permanent tax saving effected by taking a lawful deduction and passing on the benefit thereof to consumers. The tax saving effected by proper deductions is a definitely known and fixed saving for the tax year, which is certainly not true of any temporary saving effected through the offsetting of business losses against business gains. It is not the mere filing of the consolidated return but the fact of business losses having been sustained in the particular tax year which permit the temporary tax savings. The distinction must be acknowledged between the fixed and certain tax saving, and the temporary, uncertain and unascertained tax saving accomplished by utilizing business losses in a consolidated return. The latter should not be used to lower a tax allowance in a cost of service."

Completely ignoring the fact that Congress has provided that tax payers may lawfully use their tax losses to offset their taxable income in the manner provided by statute, the majority imparts its own preemptory economic and regulatory philosophy to strike down an act of Congress.

The majority cites no authority of the Commission or the Courts to sustain this onerous theory. This proceeding cannot be resolved on the basis of an imagined rationale which is in fact contradicted by the record or by the reciting of an appealing slogan. This is a clear deprivation of property without due process of law since the majority proposes to take away from the non-utility subsidiaries and the parent company valuable property rights which belong to those companies. The tax deductions given by Congress as incentives to non-utility investment should not be taken away in such manner. No company owes anyone a duty either moral or legal to incur, or to continue to incur, losses in non-jurisdictional business so that jurisdictional rates can be reduced. Following the theory of the majority, how can an integrated oil company, which also has a natural gas pipeline company within its corporate structure, compete on equal terms with an oil company not having similar pipeline operations, if the latter can use all of its tax savings in its oil business but the former cannot? Clearly, it cannot so compete.

I would reflect on a point that deserves serious consideration. All but three of the 37 corporations involved in this proceeding are, in some way, connected with the petroleum business operated by the parent company. Conceivably, the parent's business could be conducted by a departmentalized single corporate entity. If this be true, there would be no losses to offset against taxable income since the single corporation would show an overall profit although some of its departments would lose money. Under

such circumstances no consolidated return would be filed and the Commission would routinely grant to the Gas Company a tax allowance based on the statutory rate of 52%. In the instant proceeding, the majority places a penalty on the parent company because it has lawfully chosen to operate its world wide business through subsidiaries. Such a regulatory policy is unsound and inequitable.

The fact remains that Congress has given the parent company, not this Commission, the right to decide whether or not it will take advantage of the consolidated return and the benefits and obligations accruing thereunder. The Commission cannot interfere with this lawful decision of management so to conduct its business. The tax laws recognize this and they have given companies the opportunity to so operate without sustaining a tax loss because of their business activities. Congress did not commit management judgments to an administrative agency; this is the line past which a regulatory commission such as ours may not go.

If the economic advantage arising out of the filing of a consolidated tax return is to be passed on to Gas Company's ratepayers, which is the effect of the majority decision, the intent of Congress will be defeated. Here, the language of the statute is plain and unambiguous and it must be given effect according to its obvious meaning. By allowing the taxpayer the full advantage provided by the consolidated return, no attendant harm results to the ratepayers. This method does not result in higher rates to the consumer, it simply does not operate to reduce them. This view is in harmony with Section 1501 of the Internal Revenue Code, is fair to the ratepayer yet it does not constitute an expropriation of the constitutional powers of Congress.

The majority decision results in glaring defects and inequities; they have not offered any valid and compelling

reasons for their decision. Contrary to the views expressed by the majority, I believe every effort should be made to afford all legitimate and necessary incentives to private enterprise while, at the same time, protecting the consumer ratepayer.

The examiner who heard the testimony in this proceeding correctly concluded, upon the basis of the record evidence and the pertinent law and regulatory policy, that the Federal income tax allowance included in the cost of service supporting the settlement agreement approved by the Commission in its order of May 27, 1961, computed at the statutory rate of 52%, is not excessive or in any way improper, and should be approved. In my judgment, the examiner's decision should be affirmed.

/s/ Harold C. Woodward
Harold C. Woodward, Commissioner

/s/ L. J. O'Connor, Jr.
L. J. O'Connor, Jr., Commissioner

APPENDIX D

TAXABLE NET INCOME OF UNION PRODUCING COMPANY

Year	Taxable Net Income (1)	Gas Operations (Includes Both Jurisdictional and Non-Jurisdictional) (2)	Oil Operations (100% Non-Jurisdictional) (3)
1957	$(2,269,975)	$(1,486,211)	$ (783,764)
1958	4,852,736	3,430,415	1,422,321
1959	(1,958,398)	(461,366)	(1,497,032)
1960	(4,333,704)	(1,436,232)	(2,897,472)
1961	(160,285)	460,648	(620,933)
5 Year Total	$(3,869,626)	$ 507,254	$(4,376,880)

Source:

Col. (1) — Ex. 36 (Revised) (R II 24)

Col. (2) — Ex. 14-1, Sch. 2, line 12, Col. 4 (R II 6)

Col. (3) — Difference between Col. (1) and Col. (2)

Note — Gas operations of Union do not reflect income of $180,131 for amounts received for prepaid gas (Ex. 14-1, Sch. 7, p. 1, L. 10, Col. 10) (R II 15)

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 127, No. 128

FEDERAL POWER COMMISSION,

Petitioner,

and

MEMPHIS LIGHT, GAS AND WATER DIVISION,

Petitioner,

vs.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE-LINE COMPANY OF AMERICA, and TEXAS EASTERN TRANSMISSION CORPORATION,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

JOINT BRIEF OF RESPONDENTS, TEXAS EASTERN TRANSMISSION CORPORATION AND NATURAL GAS PIPELINE COMPANY OF AMERICA.

OPINIONS BELOW.

The opinion and order of the Federal Power Commission (Commission) herein (31 F.P.C. 1180; II R. 70-72) was reversed by the United States Court of Appeals for the Fifth Circuit (357 F.2d 230, II R. 70-72). That Court's opinion, which is here under review, cited *Cities Service Gas Co.* v. *FPC,* 337 F.2d 97 (10th Cir., 1964), which also reversed the Commission's decision in 30 F.P.C. 158 (1963), on the same issue.

These two appellate reversals are the only Courts of Appeals decisions on the so-called "consolidated effective tax rate" issue which is involved herein. In each case, at the Commission level, the reversed decisions were issued by three Commissioners, with two dissenters.

QUESTION PRESENTED.

The United States Court of Appeals for the Fifth Circuit, concurring with the decision of the United States Court of Appeals for the Tenth Circuit in *Cities Service Gas Co.* v. *FPC*, 337 F.2d 97 (1964), held that the Commission exceeded its statutory jurisdictional authority when, in setting rates to be charged by a natural gas pipeline company subject to its jurisdiction, the Commission reduced the "tax allowance" (and thus the rates) for that jurisdictional company by taking into account losses of other subsidiaries of the same parent corporation which were incurred in operations not subject to the Commission's jurisdiction. The question presented is whether the Commission, in setting rates for a company partially subject to Commission jurisdiction, is authorized to take into account the tax effect of profits earned and losses sustained in non-jurisdictional activities of affiliated companies that join with the partially jurisdictional company and its parent corporation in filing a consolidated federal income tax return.

STATEMENT OF THE CASE.

I. THE PARTIES

United Gas Pipe Line Company (United), whose rates were in issue in the proceedings below before the Commission, operates a natural gas pipeline system. Less than one-half of United's sales of gas are made in interstate commerce for resale, and are thus subject to Commission jurisdiction. More than one-half are made in intrastate commerce, and are thus exempt from Commission jurisdiction.

United is a wholly-owned subsidiary of United Gas Corporation (Parent Corporation), which owns and operates natural gas distribution systems in various areas of Texas, Louisiana and Mississippi and is not subject to regulation by the Commission in any degree. Parent Corporation purchases about 6½% of the gas sold by United, which comprises approximately 96% of Parent Corporation's gas purchases.

Parent Corporation is also the parent of Union Producing Company (Union), a company engaged in the exploration for, and development and operation of, both natural gas and oil production properties. *None* of Union's oil sales, and only the *interstate* portion of its natural gas sales, are subject to Commission jurisdiction. United purchases approximately 11% of its natural gas requirements from Union, which represents approximately 80% of Union's gas sales.

Parent Corporation is also the parent of United Overseas Production Corporation (Overseas), a corporation participating in an oil exploration project in Tunisia,

North Africa, which, like Parent Corporation, is not subject to Commission jurisdiction in any degree.

For purposes of paying federal corporate income tax, Parent Corporation, United, Union, and Overseas (Corporate Group) form an affiliated group that joins in a consolidated tax return filed by Parent Corporation.

Respondents Natural Gas Pipeline Company of America (Natural) and Texas Eastern Transmission Corporation (Texas Eastern) are natural gas pipeline companies which make jurisdictional purchases of gas from United and which participated in the subject rate case of United before the Commission in order to guard against unjustified rate increases to them and their customers. Petitioner Memphis Light, Gas and Water Division (Memphis) is a local distributor of gas which purchases gas from a company which purchases part of its supply from United.

II. COMMISSION PROCEEDINGS

In its rate case before the Commission, out of which these review proceedings arose, United followed the traditional method, under "cost-of-service" regulation, of including, as a component of its rates to its jurisdictional customers, an amount reflecting reimbursement of federal income taxes computed at 52% of anticipated jurisdictional income. Fifty-two percent (52%) was, of course, the actual, lawful statutory tax rate in effect during the test year for the rate case.(*)

(*) In 1964, the tax rate was reduced to 50% and to 48% for 1965 and thereafter. The rate was 52% in the years relevant to these proceedings, however (subject to surtax adjustment, which is ignored here for simplicity).

The Commission ignored the statutory tax rate and, relying on its own decision in *Cities Service Gas Co.*, 30 F.P.C. 158 (1963), (subsequently reversed, *Cities Service Gas Co.* v. *FPC*, 337 F.2d 97 (10th Cir., 1964)), rejected United's use of the normal public utility computation of a reasonable tax allowance, based on the statutory 52% of income. Instead, the Commission computed a lesser federal income tax allowance by utilization of tax reductions and losses attributable to the unrelated, nonjurisdictional and non-utility operations of affiliated companies, by means of what it referred to as its "consolidated effective tax rate" method. The Commission, below, said that the issue before it, which is now before this court, was as follows:

> A question is raised as to United's share of the federal income tax paid through a consolidated tax return filed by United Gas Corporation, its parent. Joined in the return are the subsidiaries, United, Union, and United Overseas Production Corporation. In most years Union shows a loss with a resulting reduction in taxes for the consolidated group. However, United contends that it is entitled to apply to its taxable income the statutory income tax rate in computing the amount of federal income taxes includible in its cost of service unreduced by utilization of tax reductions and losses attributable to the unrelated, nonjurisdictional and non-utility-operations of affiliated companies.
>
> The question here involved has already been determined by us in *Cities Service Gas Company*, 30 FPC 158, Opinion No. 396, Docket No. G-18799, issued July 15, 1963.(*)

(*) 31 F.P.C. at 1190, II R. 41 (footnote omitted). The mechanics of the Commission's computation are set forth in the opinion of the Court of Appeals for the Tenth Circuit in *Cities Service Gas Co.* v. *FPC*, 337 F.2d 97 (1964), and are discussed later in this Joint Brief.

The Commission then proceeded to reduce the amount of federal income taxes in United's cost of service by the same computation prescribed in *Cities Service.*

The mechanics of the Commission's computation under this method are such that the Commission ignored company boundaries, grouped as regulated companies, companies which are outside its jurisdiction under the Natural Gas Act, "apportioned" the total intercompany group tax liability among the companies of the group, and then used the amount of tax so apportioned to United to "calculate" the "consolidated effective tax rate" which the Commission used to reduce United's jurisdictional rates. Basically, under this method, what the Commission did was to utilize tax losses created by the unrelated and non-jurisdictional operations of Union and Overseas to reduce the income tax allowance to be allowed in United's cost of service, for the benefit of its jurisdictional customers. No part of the expenses which produced the losses of Union and Overseas, and no part of the losses themselves, were, of course, used by the Commission in setting United's rates.(*) Inclusion of such items would have increased United's rates.

III. COURT OF APPEALS PROCEEDINGS

United, Natural and Texas Eastern appealed the Commission's decision to the United States Court of Appeals for the Fifth Circuit. That court reversed, consistent with the Tenth Circuit's decision in *Cities Service Gas Co.* v. *FPC,* 337 F.2d 97 (1964), stating that:

(*) Nor were factors relative to Parent Corporation, which had no losses.

> We do not think there are any such fact differences between *Cities Service* and this case as call for the application of any different rule of decision. The Court in the Tenth Circuit case held that the tax allocation as made by the Commission's order was contrary to the requirements which Congress had imposed. We think the Tenth Circuit case is correct and that the principles which are announced in its opinion are here applicable and controlling. The Commission's order, using an incorrect income tax rate in computing cost of service for the fixing of United's gas rates is erroneous and must be
>
> Vacated and set aside.(*)

In *Cities Service,* the Court of Appeals held the Commission's "consolidated effective tax rate" technique invalid on the grounds, *inter alia,* that it produced a legally fallacious "tax rate" for the regulated company, Cities Service Gas Company, and that such rate was produced by the use of tax losses of companies which were outside the jurisdiction of the Commission, thus violating the jurisdictional limits which Congress wrote into the Natural Gas Act.

(*) 357 F.2d at 231.

SUMMARY OF ARGUMENT.

The Commission, in its zeal to continually devise new theories to reduce pipeline rates, has created a "consolidated effective tax rate" method which has the effect of reducing the *interstate* pipeline rates of United, which rates are subject to the Commission's jurisdiction, *because other, non-jurisdictional subsidiaries of United's parent suffer losses, and even though such subsidiary loss operations are not subject to Commission jurisdiction.* United, and Respondents Natural and Texas Eastern, oppose the Commission's invalid, one-sided theory and contend, instead, for application of the normal rate-making procedures which are consistently applied in fixing jurisdictional rates of natural gas companies—calculation of the rate making "tax allowance" by use of the actual statutory corporate income tax rate.

The only two Courts of Appeals which have considered this question have each reversed the Commission—the Fifth Circuit, below, in *United Gas Pipe Line Company, et al* v. *FPC*, 357 F.2d 230 (5th Cir. 1965), and the Tenth Circuit, in *Cities Service Gas Company* v. *FPC*, 337 F.2d 97 (10th Cir. 1964). In the only other case in which the Commission has considered the question involved herein, the Commission rejected the "consolidated effective tax rate."(*) Other Commission cases cited by Petitioners are not in point, since they deal with different facts and theories.

(*) *Olin Gas Transmission Corp.*, 17 F.P.C. 695 (1957).

The Solicitor General has admitted, explicitly in the Petition For Certiorari herein and, implicitly, in the Commission's brief, that "There may indeed be problems in the application of the particular formula used by the Commission in this case, a formula which may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group",(*) but has attempted to defend the Commission's decision on the basis that *some* method of "allocation" of the *Corporate Group's* total tax would be valid in setting *United's* rates. This conclusion is, of course, irrelevant, since this Court is faced with two specific judicial reversals of a specific invalid action by the Commission. This is not an advisory opinion proceeding.

Beyond that, however, the Solicitor General's conclusion is invalid. No "allocation" of the Corporate Group's tax is valid in these situations, because income tax liability is not a "joint cost" which is subject to "allocation". It is a specific cost which is incurred separately by each individual corporate entity. The responsibility of each operating entity for an income tax expense is separately determined and that amount can be, and under even-handed application of normal regulatory principles, should be, directly *assigned* to that entity. No "allocation" is required or permissible.

Even if an "allocation" were held to be permissible, however, it is also true that the version of the Commission's "consolidated effective tax rate" which is here under review is not a valid method. First, the essence of the

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(*) Fn. 8, p. 10 of the Petition For a Writ of Certiorari filed herein by the Commission.

procedure is to reduce the rates of United by using losses suffered by other subsidiaries of United's parent, including, and even limited to, *losses suffered in operations not subject to Commission jurisdiction,* such as Union's extensive *oil* exploration, production and sales, and the operations of Overseas, conducted entirely outside the United States. This involves a reaching by the Commission far beyond its jurisdictional power, not only to take away benefits which belong to, and are produced by, those non-jurisdictional companies, but also to have the jurisdictional rates of United depend upon the profits or losses of non-jurisdictional operations of those other companies. Such jurisdictional violation is invalid under repeated decisions of this Court. See, for example, *Panhandle Eastern Pipe Line Co.* v. *FPC,* 324 U.S. 635 (1945) and other cases cited in Section II-A of Argument, *infra.*

Second, the Commission's "allocation" of tax, apart from jurisdictional questions, also is inconsistent with the basic principles of regulatory law, which it otherwise follows, with regard to United, that only the operations of the entity whose rates are being set may be considered in compiling costs to fix those rates. The Commission honors this by setting separate rates, in separate rate cases, for United and Union. Yet now the Commission has violated these principles, selectively, in the "consolidated tax" area. The arguments raised in support of this violation by Petitioners, Commission and Memphis, attempt to justify the Commission's action on the basis of claims that United and Union (ignoring Overseas) are "related." Those claims, however, even if they were all correct, are not sufficient to validate the jurisdictional and "regulatory separation" violations. In addition, most of those

claims are unsupported in the record or in the Commission's findings and many of the claims are inaccurate, and others irrelevant in this context, as is demonstrated in detail in Section II-B of Argument, *infra*. These include the attempt to refute the conclusive fact that the consolidated tax return here produced no overall saving to the Corporate Group, and that the inclusion of United in the group consolidated tax return *increased the tax of the Corporate Group by an amount equal to the full 52% of United's taxable income.*

Finally, the Commission's "consolidated effective tax rate" method is in contravention of the purpose of Congress in authorizing the filing of consolidated tax returns. That purpose is to allow corporate systems which include companies with losses to make current use of those losses to reduce current taxes, thus providing current funds and incentive to encourage risk taking. But the Commission's "consolidated effective tax rate" method takes those funds, and thus that incentive, away by reducing United's rates.

ARGUMENT.

INTRODUCTION

This case presents an extreme example of Federal Power Commission attempts to reduce the rates of natural gas pipeline companies, which has led the Commission to unlawful action. In carrying out its regulatory responsibilities, the Commission has twisted, and ignored, not only the jurisdictional limits upon it, but also the regulatory principles which the Commission applies in all other situations—avoidance of "allocation" of costs when direct "assignment," upon the basis of a determination of responsibility, is possible; separation of rate determinations, and rate structures, for different types of operations; and the necessity to give effect to the intention of Congress in allowing consolidated income tax returns.

In doing this, the Commission has developed an artificial technique. The one-sided purpose of that technique is shown by its "one-way" effect—that under the Commission's method, a "consolidated effective tax rate" will be applied to pipeline rate-making only if it produces a "tax rate" which is *lower* than the statutory rate. As the Commission itself states, its "allocation" of tax applies only "*provided* that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate-making purposes, if computed on a separate return basis."(*)

The Commission's one-sided psychology is at least hinted at on page 22 of the Commission's brief herein, with the

(*) *Cities Service Gas Co.*, 30 F.P.C. 158, 164 (1963).

statement that "We need not go so far as to suggest that as partners, the ratepayers were entitled to share in the profits produced by the oil operations." Even to suggest this possibility, even though seeming to reject it, is to exhibit the Commission's lack of concern for legal and equitable limitations, which has produced a tax "allocation" method that *does,* in fact, appropriate a portion of non-jurisdictional oil losses for reduction of jurisdictional rates. And it must be noted that the Commission's procedure is based on the fundamental inequity that it does not increase United's rates because United's fellow subsidiaries have more expenses than income; but does decrease United's rates because of the tax effect of those losses suffered by the fellow subsidiaries.

Although the Commission itself may think it has produced a viable "allocation" method, the Solicitor General obviously doesn't share that attitude. Instead, the Solicitor General (Brief, p. 15) takes great pains to argue that the question involved here is not whether the *type* of "allocation" imposed upon United by the Commission is valid, but rather whether *any* "allocation" which might be designed could be valid. And in the Commission's Petition For a Writ of Certiorari herein (fn. 8, p. 10) the Solicitor General admits that:

> There may indeed be problems in the application of the particular formula used by the Commission in this case, a formula which may result in allocating the *entire tax saving* resulting *from losses on unregulated* activities to the *regulated* members of the consolidated group. (Emphasis added)

Thus, this Court is being asked to uphold the Commission's decision, which reduces United's rates and income, and to reverse the Fifth and Tenth Circuit Courts of

Appeals on the basis that the Commission *might* be able to produce a valid "allocation" method in the future. For the reasons outlined in this brief, Natural and Texas Eastern do not believe the Commission could devise such a valid method. There are too many inherent defects in their theories.

But that is not the question. What is here under review is a Commission decision which is clearly invalid. It is so extreme that it produces the anomalous result that when the non-jurisdictional operations of the Parent Corporation's other subsidiaries produce *losses, United's* rates are *reduced.* But United's rates would not be reduced if those non-jurisdictional fellow subsidiaries had profits. Apart from considerations of legality, this is not even reasonable.

United merely wishes to have its rates computed by the normal principles of ratemaking. Its rejection of the "consolidated effective tax rate" method does not increase its rates over what they would normally be. Those rates simply would not be reduced by the Commission's invalid theory.

I.

THE COMMISSION'S "ALLOCATION" OF TAXES WAS UNNECESSARY AND ERRONEOUS.

As described earlier, the Commission action which was reversed by the court below (as was an identical action in *Cities Service*) was the creation of the Commission's own "tax rate" for the jurisdictional pipeline, the substitution of that rate in place of the higher, actual statutory tax rate, and the use of that new, lower rate to calculate the tax allowance portion of the "cost of service" from which the rates of the pipeline are derived. The result of

such actions was to reduce the jurisdictional rates of the pipeline.

The method used by the Commission starts with the total tax liability of the entire Corporate Group of which United is a part, "allocates" the total tax among the companies in the group, without regard to the source of the taxable income which results in such total tax, and then compares the tax so "allocated" to United to the taxable income of United, to compute the Commission's own "consolidated effective tax rate."

The premise of the Commission's theory is that an "allocation" of tax is necessary, and the Commission devotes the "Introduction" of its Argument (Commission Brief, pp. 12-15) to an attempt to convince this Court that an allocation of the total Corporate Group tax was required in order to determine United's tax allowance. In fact, however, no allocation was required or permissible, for the following reasons.

A cost "allocation" is a division of costs on some "reasonable" estimated basis. An "assignment" of costs is simply a determination that a given cost was incurred for or caused by a given operation and thus is to be "assigned" to that operation on the basis of responsibility. Thus, where there are costs which must be divided among operations, the more precise "assignment" is used first, and the more imprecise "allocation" estimates are to be used only with regard to "joint costs" which cannot be assigned.

The Commission itself recognized the above elementary facts in this present case, stating:

> We think it a desirable principle of rate making that costs should be directly assigned whenever feasible,

and cost allocation with all of its complexities should be employed only when necessary.(*)

Despite the above facts, the Commission continues to allege that an "allocation" of tax liability is necessary. To try to prove this, the Commission, at page 12 of its Brief, attempts to use examples and points to "rent paid by *the concern* for occupancy of a building housing both pipeline and non pipeline employees", and the salary it pays its "comptroller who keeps all the books of *the concern*" (emphasis added) as examples of "joint costs" which *must* be "allocated." In actuality, such items, considered in the abstract way in which they are posed by the Commission, may or may not be "joint costs," and thus an allocation may or may not be needed. In this regard, it is significant that the costs are referred to, in the Commission's brief, as quoted above, as costs of "the concern." What if there are, as in the United system, several "concerns", each housed in the same building? Could not the building owner charge each corporation separately for rent for the portion of the building occupied by each corporation? In that case, no "allocation", between the corporations, of the total rent is needed. If but one rental bill is rendered for the entire building, however, then an allocation is required.

Similarly, the comptroller could sign an employment contract which provided that he be paid separately by *each* corporation. In that case, no allocation of his total salary would be needed. If his contract provided for one undifferentiated payment, however, and he served more than one corporation, or operation, then his salary must be "allocated."

(*) 31 F.P.C. at 1197 (II R. 48).

The Commission's examples of the need for allocation of cost *savings* (at page 13 of its Brief)—refunds of a portion of the rent or of the comptroller's salary—give equally uncertain results. Again, the Commission did not go far enough in its analysis. Just as with "joint costs" themselves, savings of, or reductions in, "joint costs" must be allocated *if they are attributable to both pipeline and non-pipeline operations.* Thus, it is the *reason* for a reduction or saving which is crucial in deciding whether an allocation is appropriate.

Assume that the landlord who refunds a portion of the rent does so because certain employees of the oil operations of the non-pipeline affiliate move to other quarters and give up use of part of the building. In that case, the "reduction" or "saving" in rent clearly would be assignable directly to the oil operations without "allocation". Similarly, suppose that the comptroller, in the Commission's example, returns a portion of his sala , not because it was paid by mistake, but because he no longer performs certain duties formerly carried on for the *non-pipeline* affiliate. Should that "reduction" or "saving" in salary expense be allocated, in part, to the *pipeline,* in that case? Obviously not. The reason is that in both of the above cases the "reduction" or "saving" is wholly attributable to one of the divisions or affiliates, and there is no need to "allocate" that "saving." Rather, the saving should be *assigned* to that particular division or affiliate which causes the saving.

In light of the above analysis, the Commission's assertions as to the need for "allocation" of the total Corporate Group income tax liability may be seen to be clearly inaccurate. Each company in the Corporate Group in which United is a subsidiary incurs its *own* tax deductible ex-

penses and earns its *own* income. And each company's income tax, which results from the application of the statutory rate to its own net taxable income is reported separately on an income tax return to form the basis for the Corporate Group consolidated tax liability.(*) These *separate* corporate tax computations are cumulated in the consolidated group tax return. Thus, it is not only separately computable, it is obvious, what effect each corporation in the group has on the consolidated tax. United, for example, had taxable profits in each of the five test years. Therefore, its inclusion in the consolidated returns increased the total system tax by 52% of United's taxable income. And that 52% amount is a finite, separately determinable and determined cost of United, which the Commission should have "assigned" to United's "cost of service." There was no need to "roll" United's tax into the total system tax and then "allocate" a portion of the total *group* tax back to United.

Exactly the same thing is true when we deal with consolidated tax "savings." If a company with a taxable loss is included in a consolidated tax return, its loss will be set off against the profits of other companies. Thus, in the particular year in which the loss occurs, the taxable income of the overall consolidated group is less than the sum of the taxable profits of the companies which have profits, because the losses of the "loss companies" are deducted from those profits. This causes what appears, in the first instance, to be a "saving" in tax for that year.(**)

(*) 26 C.F.R. 1.1502-31(b)(1), (2)—applicable to taxable years before 1966.

(**) But see Section III-B2 of Argument, *infra*.

That "saving," however, is wholly attributable to the losses of the "loss companies" in the group—in these proceedings, to the losses produced by the non-jurisdictional activities of United's fellow subsidiaries—and is in no way attributable to United and its ratepayers. Just as the above described rebate in rent, occasioned by a decrease in space contracted for by a *particular* division or affiliate, or a "refund" of salary, occasioned by decreased duties performed for a *particular* division or an affiliate, is directly assignable to that division or affiliate, so are *tax losses* incurred by a *particular* division or affiliate assignable to *that* division or affiliate.

Thus, it can be seen that both the portion of the tax of the Corporate Group which is caused by United's jurisdictional operations, and the tax "saving" caused by other companies in the system, are directly ascertainable and thus can be "assigned" to those companies. There is, therefore, neither necessity nor justification for an "allocation" of total group tax—the separate tax liabilities can be directly ascertained, so that there is no need to start with the total, and attempt to decide upon an "equitable" allocation.

This is what the Tenth Circuit held in *Cities Service* (adopted by the Fifth Circuit in *United*, below) when it said:

> We think it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent Company. This approach cannot be justified by the actualities of the case. The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52 percent rate, but its tax liability at that rate was reported

to the parent Company, and the consolidated returns actually reflect that tax liability.(*)

Thus, the first basic premise of the Commission's argument—that an "allocation" of tax is proper at all—is shown to be erroneous.

It is also true, however, that even assuming, *arguendo*, that an allocation were required, the Commission's "allocation" is invalid because it inevitably exceeds the Commission's jurisdictional power, ignores the separate business activities within the consolidated Corporate Group, is based on the erroneous premise that tax "savings" are created by use of a "consolidated return" and violates the purpose of Congress in enacting the consolidated tax provisions of the Internal Revenue Code. These facts will be shown in succeeding sections of this brief.

II.

THE COMMISSION'S ACTION EXCEEDS ITS JURISDICTIONAL AUTHORITY.

A. A Fundamental Principle Of Rate Regulation Under The Natural Gas Act Requires The Commission To Separate Jurisdictional And Non-Jurisdictional Expenses.

A fundamental principle of rate regulation under the Natural Gas Act, articulated by this Court in *Panhandle Eastern Pipe Line Co.* v. *FPC*, 324 U.S. 635 (1945), for example, requires the Commission to disregard the profits and losses of non-jurisdictional activities in considering just and reasonable rates for the service rendered by a jurisdictional company or operation. The reasons for this are obvious. Users of a public utility service should not be forced to bear the cost of non-jurisdictional opera-

(*) 337 F.2d at 100.

tions or enterprises, nor should they have any right to share in the profits of non-jurisdictional divisions or affiliates of a utility group, via lower rates.

But the "consolidated effective tax rate" method, as applied by the Commission in this case, which is analyzed hereinbelow in subsection B of this Section II, produces just that prohibited result. Use of that theory in rate-making by the Commission has the inevitable effect of assigning the current income tax reductions, which result from the losses of non-jurisdictional operations of affiliates, to United and its ratepayers. This is in violation of the holding of this Court, in *Panhandle*, that:

> We agree that the Commission must make a separation of the regulated and unregulated business when it fixes the interstate wholesale rates of a company whose activities embrace both. *Otherwise, the profits or losses, as the case may be, of the unregulated company would be assigned to the regulated business and the Commission would transgress the jurisdictional lines* which Congress wrote into the Act. (Emphasis added)(*)

Further, the Commission itself, in its decision below, recognized the vitality of that principle and acknowledged its duty to abide by it.(**) But while it followed that principle in determining all other elements of United's jurisdictional cost of service, it wholly failed to do so in fixing United's income tax allowance.

(*) 324 U.S. at 641-42. See also, for example, *Panhandle Eastern Pipe Line Co.* v. *Public Service Commission of Indiana*, 332 U.S. 507, 516 (1947); *FPC* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 503 (1949); *Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581 (1945).

(**) 31 F.P.C. at 1190-91 (II R. 41-42).

B. The Commission's Method In This Case Improperly Credits United's Rates With Reductions In Tax Expense That Are Wholly Attributable To The Non-Jurisdictional Activities Of United's Affiliates.

The effect of the Commission's "consolidated effective tax rate" method, which violates the principles shown in the preceding subsection herein, is to use the reduction in income tax resulting from losses of companies outside the jurisdiction of the Commission to reduce the rates which United is allowed to charge for the portion of its services which are subject to the Commission's jurisdiction. Commission Staff counsel admitted, at the hearings below, that this was the effect of the consolidated effective tax rate,(*) and Petitioners and Respondents are in agreement with regard to the facts which prove the conclusion that it is non-jurisdictional tax losses of other companies which are used to reduce United's rates—that it is the deduction of the tax losses of the non-jurisdictional operations in the group from the jurisdictional profits, which allows the mathematics of the Commission's method to produce a "consolidated effective tax rate" lower than 52%,(**) which, in turn, reduces the jurisdictional revenues of United.

That is what happened in *Cities Service,* and the Commission applied, in this case, the method it first advanced

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(*) At I R. 120, he "stipulated" that the reduced "tax rate" applied to United resulted from "taking into account Union's losses on oil as well as Union's losses on gas."

(**) See 357 F.2d at 231, 30 F.P.C. at 164 and 31 F.P.C. at 1190.

in *Cities Service*. The Commission recognizes that its method uses non-jurisdictional losses to reduce jurisdictional rates and has expressly stated, as noted earlier, "There may indeed be problems in the application of the particular formula used by the Commission in this case, a formula which may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group." (p. 10, fn. 8, Commission Petition For a Writ of Certiorari herein.)

And that is just what happened below. Under the formula used by the Commission, practically all of the tax losses of Overseas, which resulted from its non-jurisdictional oil activities outside the United States, and of Union, which resulted from Union's unrelated and non-jurisdictional activities, were used to reduce United's income tax allowance in its cost of service and, thus, its jurisdictional rates. To use these unrelated and non-jurisdictional tax losses to reduce United's jurisdictional rates plainly transgresses the jurisdictional limitations which Congress wrote into the Natural Gas Act. Just as the Commission cannot regulate the rates of non-jurisdictional companies, or non-jurisdictional activities, directly, it cannot do so indirectly by appropriating "non-jurisdictional" tax losses through the device of reducing United's "jurisdictional" rates because of such losses. This device, like direct regulation of the non-jurisdictional "loss companies", reduces Corporate Group income because of the non-jurisdictional operations of Union and Overseas, which the Commission is not empowered to affect. And the "consolidated effective tax rate" device would make the tax allowance, and hence the jurisdictional rates of United, vary depending upon the taxable profits or losses

of the non-jurisdictional affiliates, which is equally invalid.(*) As the Tenth Circuit held, in reversing the Commission's "consolidated effective tax rate" method in *Cities Service*:

> We know, of course, that the Commission is free to choose most any method which it deems appropriate in the determination of just and reasonable rates for jurisdictional gas sales—usually a legitimate end justifies the means. See: Colorado Interstate Gas Co. v. F.P.C., supra; Panhandle Eastern Pipe Line Co. v. F.P.C., supra; Wisconsin v. F.P.C., 373 U.S. 294, 83 S. Ct. 1266, 10 L. Ed. 2d 357. But, we know equally well that the method utilized must surely be within acknowledged jurisdictional limits which require an effective separation of regulated and nonregulated activities for the determination of the ingredients of the rate base. As applied to our case, it means a separation of profits and losses between regulated and nonregulated businesses in determining the tax allowance includible in the cost of service of the regulated company. "Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which

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(*) United points out in its brief that all of Union's tax losses result from its oil operations—that Union's natural gas operations produced taxable income. Even if, however, both the jurisdictional and non-jurisdictional operations of Union had produced losses, it would still be true that *all* losses of Union, under the Commission's method, as well as the wholly non-jurisdictional losses of Overseas, would have the effect of reducing United's rates. The Commission's theory would, under those conditions too, violate the Commission's jurisdictional power, since some non-jurisdictional losses would be seized and used to reduce the jurisdictional rates of United.

Congress wrote into the Act." Panhandle Eastern Pipe Line Co. v. F.P.C., supra, 324 U.S. pp. 641, 65 S. Ct. p. 285.

And, as we have seen, the total tax liability is not affected when the Gas Company's tax liability at the 52 percent rate is included in the consolidated returns. Rather, the reduction in the total tax liability effected by the consolidated returns is due to the losses of the nonregulated companies. But, even so, under the Commission's method, the tax allowance of the Gas Company is made to depend upon the profits or losses, as the case may be, of the nonregulated companies.

It is thus plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the Act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside.(*)

C. Even The Commission's Supposed "Regulated," "Non-Regulated" Categories Demonstrate The Commission's Violation Of Its Jurisdictional Powers.

The Commission's "consolidated effective tax rate" method involves, as the Commission stated in its *Cities Service* opinion, the following steps:(**)

(*) 337 F.2d at 100-101. At the Commission level, two of the five Commissioners, Messrs. Woodward and O'Connor, dissented from the Commission's *Cities Service* decision, stating: "[T]he majority view is unlawful because it has the effect of regulating non-utility enterprises beyond the Commission's jurisdiction; . . ." (30 F.P.C. at 172)

(**) 30 F.P.C. at 164 (repeated by the Commission in *United*, below, 31 F.P.C. at 1190).

> . . . (1) separate the companies [which join in filing a consolidated return] into *regulated and unregulated groups,* (2) determine the aggregate taxable income of *each group,* and (3) apportion the net total consolidated tax liability over a representative period of time between the *two groups* . . . (Emphasis added)

Thus, the meaning of "regulated" group and "unregulated" group is central to the Commission's method. But the Commission's definition of "regulated" and "unregulated" ignores its jurisdictional limits. The Commission uses "regulated" to mean regulated by *some* agency, but not necessarily by the Federal Power Commission. Thus, even when acting within the bounds of its own "regulated" category, the Commission exceeds the limits of its jurisdiction. This is made clear at 31 F.P.C. at 1190-91, where the Commission stated that it had classified United Gas Corporation (the parent of United) as a regulated company because it "engages in the distribution of gas and its rates are variously subject to regulation *by state commissions and municipalities.*" (Emphasis added).(*) It can be seen, therefore, that the method used by the Commission has, as its first steps, a procedure which ignores the jurisdiction of the Commission itself and deals with

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(*) The Commission, in its attempt to find any way to reduce pipeline rates, is not even consistent in its categorization of companies. Thus, Union, although its interstate sales of gas are subject to Commission jurisdiction, seems to be classified as "unregulated," although the Commission seems ambivalent and even goes so far as to say it does not really make any difference how Union is classified. (31 F.P.C. at 1191)

an irrelevant category—the category of companies subject to regulation by some agency.(*)

The Natural Gas Act limits the regulatory authority of the Commission to the transportation and/or sale of natural gas in interstate commerce for resale.(**) The Act does not give the Commission regulatory authority over the local distribution of gas, nor does the Act give the Commission regulatory authority over any aspect of the oil business or over the affairs of a company engaged in overseas exploration for gas and oil. The Courts of Appeals for the Tenth and Fifth Circuits properly have held that the consolidated effective tax rate method of apportionment of the total tax liability among the regulated companies, devised by the Commission in *Cities Service* and used by it in the proceedings below, fails to comply with those jurisdictional requirements.

(*) It should be noted that had the Commission's method used *jurisdictional* and non-jurisdictional separation, the non-jurisdictional profits would have more than offset the non-jurisdictional losses. That would have meant that even under the Commission's method, United's tax rate would not have been reduced. Therefore, the Commission simply reshaped its own method to get a desired result, but exceeded its jurisdictional power in the process. See Exhibit 36, II R. 24.

(**) 15 U.S.C. §717(b).

III.

EVEN APART FROM JURISDICTIONAL VIOLATIONS, THE CLAIMS OF "PRACTICAL" JUSTIFICATION BY THE COMMISSION ARE ERRONEOUS AND ALSO CANNOT OVERCOME THE FACT THAT THE OPERATIONS OF THE AFFILIATED COMPANIES ARE SEPARATE FROM THOSE OF UNITED.

A. The Commission Violated Principles Of Regulatory Law Which The Commission Otherwise Follows.

In dealing with the Corporate Group of which United is a part, the Commission follows the basic principle that the identity of the entity being regulated in a given case must be determined, and only the operations of that entity may be considered in determining its rates. Where jurisdictional questions are involved, then such separation of operations is even more imperative. In setting the rates of United, for example, the Commission must, and does, separate costs between United's own jurisdictional interstate sales and its non-jurisdictional intrastate sales. The Commission, quite properly, does not include, as a cost to be paid by United's interstate customers, any of the costs and expenses of carrying on United's non-jurisdictional operations. Further, the Commission does not impose on jurisdictional ratepayers the costs incurred by non-jurisdictional affiliated companies.

Even when no question of Commission jurisdiction is involved, however, separate operations must be honored. The Commission knows this and normally follows that principle. For example, the interstate natural gas operations and sales of *both* United and Union are regulated by the Commission. Nevertheless, the Commission respects the separate operations and separate operational and corporate identities of the two affiliated companies, and does

not attempt to regulate the companies together. Each company has a separate rate structure, and their rates are fixed in wholly separate rate cases.(*) There is no mixing.

However, the Commission violated these principles in its "consolidated effective tax rate" method. Not only is it beyond the Commission's jurisdiction, but it is also completely unreasonable for the Commission to attempt to use *affiliates'* losses to reduce *United's* rates, for "consolidated" expenses bear no reasonable relationship to the actual expenses incurred by United. Those expenses are incurred in relation to, and are needed to earn, the actual separate company income of United. Yet the Commission would cut the rates, and thus the income, of United, but its expenses would not be reduced. And the Commission would ignore the fact that there is no equitable or legal basis for the Commission to give the jurisdictional customers of United the benefits of *any* losses which result from the businesses of its affiliates. None of the costs and expenses of the affiliates—jurisdictional or not, and regulated or not—were included by the Commission in United's jurisdictional cost of service.

Thus, in this proceeding, except for the income tax allowance included in United's cost of service, the Commission has stayed within proper lines and fixed United's jurisdictional rates solely on the basis of its own jurisdictional costs, expenses and revenues. Thus, in determining United's jurisdictional cost of service, the Commission quite properly did not include *any* of the costs and expenses of United's non-jurisdictional operations or of con-

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(*) See, for example, the proceedings of United, below, 31 F.P.C. at 1187-89, and the separate proceedings of Union, *Union Producing Co.*, 31 F.P.C. 41 (1964).

ducting the businesses of United's affiliates. However, in devising the "consolidated effective tax rate" method, the Commission, while recognizing the fundamental rate-making principle which requires the recognition of separate profits in the determination of the tax allowance, has failed to comply, either in *Cities Service* or in these proceedings, with that requirement. Instead, the Commission has reduced United's rates because of the tax losses of separate, albeit affiliated, companies, which carry on separate kinds of operations. It is completely illogical to take into account tax losses of separate affiliates and operations, and not give affect to the revenues and expenses which create those losses. The Commission cannot—and did not—do the latter, yet it did the former.

B. The Claims Of "Practical" Justification By The Commission And Memphis Are Both Insufficient And Erroneous.

The Commission ignores the jurisdictional question and, instead, devotes 12 of the 16 pages of its Argument (Brief, pp. 12-23) to an attempt to justify its actions by answering only the point demonstrated in subsection A, above, by arguing that United and its affiliates are really not separate operations at all and thus are entitled to "share" each other's tax losses. The brief of Petitioner Memphis, too, finds it difficult to use the word "jurisdiction". Instead, Memphis also devotes the greater part of its Argument to claims that United and its affiliates are so interrelated as to justify the Commission's procedures.

Those "practical" claims of "interrelation"—which are advanced by the Commission and Memphis in an attempt to justify the use of tax losses of United's fellow subsidiaries to reduce the rates of United—will be specifically

answered in this section. First, however, it is necessary to note two points:

(1) Even if all of such claims of interrelation between affiliates were correct, they could not justify the jurisdictional violation which necessarily results from the Commission's "consolidated effective tax rate" method. When a regulatory agency acts beyond the boundaries of the authority granted to it by Congress and this Court, its action cannot be made lawful by claims of "practical" justification.

(2) Apart from jurisdictional considerations, it is also true that even if the "practical" arguments of the Commission and Memphis were correct, they could not justify the use of non-pipeline tax losses (and the income and expenses, of the other companies, which produced those losses) to reduce United's pipeline rates.

Natural and Texas Eastern will now turn to consideration of the accuracy of the legally insufficient "practical" arguments of the Commission and Memphis.

1. *Classification Of Union As "Regulated" And "Related" Is Both Meaningless And Inaccurate.*

Memphis first devotes Section I, pages 17-20, of its brief to creating and defeating a straw man argument. That is, Memphis repeats the portion of the third paragraph of the opinion of the Tenth Circuit in *Cities Service*(*) which asks whether the Commission could use the "losses of nonregulated and unrelated affiliates to calculate the tax allowance includible in the cost of service of a regulated company." Memphis then goes on to try

(*) 337 F.2d at p. 98.

to prove that Union, as a corporate entity, is "regulated" and "related." This, however, is pure straw man tactics, because the *holding* of the Court of Appeals(*) was *not* that the Commission's method was unlawful because Union was not "regulated" and "related"—it was that such method was unlawful because it violates the *jurisdictional* authority of the Commission by using losses of "nonregulated businesses" to reduce the tax allowance of the company whose rates the Commission is examining. In this jurisdictional context, it is clear that the Tenth Circuit, when it says "nonregulated," means "not subject to Federal Power Commission jurisdiction," not the "regulated by *someone*" definition created by the Commission.

Even if the *general* "regulated" and "related" status of Union(**) were the central point in the Tenth Circuit's decision, however, it is clear that Union does not qualify. As to "regulation," none of Union's oil operations are regulated by anyone. Memphis argues that Union's oil is largely produced from *fields* which also produce gas, and seems to suggest that this changes Union's unregulated status as to oil. It does not, and Memphis does not point out why it thinks it does, or should. But Memphis does misleadingly imply that gas consumers pay oil exploration

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(*) 337 F.2d at pp. 100-101.

(**) Overseas, of course, is not subject to regulation by any agency, so that the Memphis argument is wholly inapplicable to Overseas. Memphis and the Commission try to pass off, as *de minimus*, the use of the losses of "nonregulated" Overseas to reduce United's rates. Yet, it is the Commission which wants this Court to rule *only* on the question of principle behind its "consolidated effective tax rate" theory. If only "principle" is involved, even true *de minimus* examples are relevant.

costs, when in fact, the Commission, in fixing Union's jurisdictional rates, separates out all non-jurisdictional oil costs and the gas consumers pay only the costs fairly apportioned to jurisdictional *gas* exploration, production and sales. And United does not buy Union's oil. Further, Union's non-jurisdictional gas operations are also not regulated by the Commission.

Memphis ends up by arguing that *El Paso Natural Gas Co.* v. *FPC*, 281 F.2d 567 (5th Cir., 1960), requires approval of the Commission's "consolidated effective tax rate" method. The simplest answer to this argument is that the Fifth Circuit decided both *El Paso* and *United*, below, and obviously disagreed with Memphis. The Court did not even mention *El Paso* in *United*. The reason is clear. First, of course, no consolidated tax return or "effective tax rate" was involved in *El Paso*. But beyond that, *El Paso* held that the pipeline must consider *its own* tax deductions which arise from its own jurisdictional gas operations, in calculating *its own* tax allowance for *gas* rates, but the case did not, as does the instant proceeding, involve the use of the tax losses of other companies, which arise from non-jurisdictional operations of those other companies, including oil operations, to reduce the pipeline's jurisdictional gas rates.(*)

2. *The Claim That United's Profits Are Necessary To Use Non-Jurisdictional Losses Is Both Inaccurate And Irrelevant.*

The briefs of both the Commission (pp. 16-17) and Memphis (p. 22) also argue that United's rates should be reduced by the losses of Union and Overseas because,

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(*) *El Paso Natural Gas Co.*, 22 F.P.C. 260 (1959).

under the consolidated tax return procedure, the profits of United are necessary in order to gain tax saving benefits from those losses. First, this is irrelevant to jurisdictional questions. Second, the claims are not true, because there are more than enough non-jurisdictional profits in the group to absorb those losses. Parent Corporation, in fact, alone had enough profits to do just that.(*) Finally, Petitioners' claim seems to suggest that a consolidated tax return is the only way to utilize tax losses. In fact, it is not, so that Petitioners err by assuming that a group of corporate affiliates receives an overall tax "saving" by filing a consolidated return rather than separate returns. That error may be explained as follows. Income earned by a large corporation during a particular period of time—the taxable year—is taxed at a 52% rate.(**) An ungraduated income tax administered in this way will produce, over a period of several years, a tax of exactly 52% of the corporation's income for those years, if the corporation has income in each year. This is not necessarily true, however, when a corporation has incurred losses in some of those years. In that case, unless those losses are somehow credited, for tax purposes, against the income realized during the profitable years, the sum of the taxes paid by the corporation will exceed an amount warranted by the actual profits of the corporation. For example, if a corporation were to have income of $1,000,000 in the first year, losses of $1,000,000 in the second year, and profits of $1,000,000 in the third year, strict adherence to a "taxable year" concept would

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(*) See Commission Brief, p. 6; II R. 53.

(**) The recent change in tax rate does not change the results described here.

result in the corporation paying no tax in the second year and being taxed at a 52% rate on the profits of the first and third year, so that $2,000,000 would be taxed. Viewed realistically, however, the corporation had profits of only $1,000,000 for the three year period. Thus, strict adherence to the "taxable year" concept in such a situation would result (at a 52% rate) in the corporation paying more taxes than it had income.

In recognition of this fact, Congress provided, in Section 172 of the Internal Revenue Code of 1954,(*) "carrybacks" and "carryovers" which allow corporations experiencing alternating periods of profit and of loss to pay taxes that realistically reflect actual income over a period of time longer than the "taxable year." Losses incurred in one year are used to reduce income, and consequently taxes, in other years. For example, in the above hypothetical situation, the corporation would be allowed to adjust its income for tax purposes in the first year by the amount of its loss in the second year, thus cancelling out its income for the period. While this method has the disadvantage of not necessarily accurately matching the tax payable in a particular year with income for that year, it does insure that the taxpayer will be assessed, over a reasonable period of time, a tax representing no more than 52% of its actual overall income. No "saving" is involved. The taxpayer is not taxed at a rate less than 52% as a result of the carryover and carryback provisions of the Code. Those provisions simply decrease what would otherwise be an excessive tax, of more than 52% of actual income, to a 52% figure.

(*) 26 U.S.C. §172.

The filing of a consolidated return by an affiliated group has exactly the same effect. Under the consolidated return procedure embodied in Sections 1501-1504 of the Code,(*) eligible corporations may pay a tax each year that is computed on the basis of the income of the entire group, rather than on the separate incomes of the affiliates. As a result, losses incurred by any one of the corporations reduces the income on which the tax is imposed, in the same year that the loss is incurred. Thus, actual consolidated income of the group is taxed at a 52% rate for that period, rather than at the higher actual rate, which would result from failure to include the losses. Taxes are therefore "reduced."

That reduction does not give anyone any "saving," however. On the contrary, the effect of the utilization of a consolidated return is merely to reduce what would otherwise be an excessive tax of more than 52% of actual income to a 52% figure. While this same result can be obtained on a separate return basis, by taking advantage of carryover and carryback credits, the use of the consolidated return has the additional advantage of allowing losses to be reflected in taxes for the year in which the losses were incurred, rather than in preceding or subsequent years.

The Commission, however, has proceeded on the theory that the use of a consolidated return results in an overall tax "saving," because one of the members of the group had a tax loss. In doing so, it ignored uncontradicted expert testimony to the effect that if it had needed to do so, Union could have, and would have, utilized any carry-

(*) 26 U.S.C. §§1501-1504.

over or carryback credits it might have acquired during the test period. As Mr. Dunn, an accountant with a broad background in matters of this nature, testified:

> I have made a study . . . and that study proves conclusively that whether a consolidated return basis is used or a separate return basis is used, Union, itself, can use all of its tax deductions.(*)

Thus, the Commission ignored *two facts*: First, that a corporation like Union can control the years of its profits and losses to take advantage of its tax credits, and second, that even without using such control, Union, as admitted by Memphis (Brief, p. 23), had profits in 1958 sufficient to itself absorb over one-half of its losses from 1957-61. If it had been necessary, *all* losses could have been offset. As Mr. Dunn testified (I R. 100):

> Furthermore, of course, Union being a producing company, its tax deductions are controllable. Union can control how many wells it drills in any year, and one of the main items of tax deduction is well drilling expense, both producing wells and non-producing wells, and in any given period of time Union can control to a very large extent how many wells it drills, so that there is no reason whatever to assume that Union Producing Company, being a highly successful production company and with large gas and oil reserves, proven oil reserves, would ever be in a position of not being able to utilize its tax deductions.

It is clear that the Commission erred in reducing United's rates to reflect a tax "saving" when, in fact, no tax saving was realized by the Corporate Group by use of the consolidated return. The Commission's brief argues that the "carryover, carryback" provisions of the Internal

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(*) I R. 71-72.

Revenue Code are not available to an individual company like Union if it participates in a consolidation. That is an artful, but irrelevant, argument. The Commission is trying to reduce United's rates by use of Union's losses *because,* the Commission says, *the consolidated tax return* produces a tax saving *which United, in part, makes possible by enabling there to be a consolidated return.* But, as just shown, the fact is that the consolidated return produces no tax offset which could not have been achieved *by Union alone,* if the system had chosen to do it by carryover and/or carryback, rather than through a consolidated return. Since the income of United and Parent Corporation was thus not actually needed in order to allow Union to take tax advantage of the losses it sustained, the Commission's primary "practical" argument for its unlawful "effective consolidated tax rate" theory is not only legally insufficient, but is also groundless.

3. *Petitioners' Claims Based On Inter-Corporate Finances Are In Error.*

In another effort to show irrelevant "relation" of United and the loss companies, the Commission, at pages 20-21 of its Brief, argues that United's profit "furnishes an important cushion against entrepreneurial risks" in such fields as oil and gas production. This argument ignores two facts. First, United's jurisdictional revenues are set by the Commission at a "just and reasonable" level *for pipeline* operations.(*) No extra amount is allowed because there is a producer affiliate in the Corporate Group. Second, the Commission admits (Brief, p. 21) that it is

(*) This assumes that the predicted sales will, in fact, be made at that rate level, so that profits will be realized. This is not guaranteed.

Parent Corporation, not United, which invests in Union. Thus, if any of United's pipeline profits are invested in Union's activity, it is because funds which were paid to Parent Corporation as dividends, and thus could have gone to stockholders of the parent as dividends out of profits, were instead reinvested. Merely because Union and Overseas suffered losses in their operations conducted with funds of Parent Corporation's stockholders hardly provides a reason to reduce *United's* rates.

The Commission (Brief, p. 21) also argues that the presence of Union in the Corporate Group increases the capital costs of United. In fact, the Commission, in United's rate case used *Parent Corporation's* cost of capital because it was *lower* than United's. (*United Gas Pipe Line Co.*, 25 F.P.C. 26, 110 (1961)). Since Union affects Parent Corporation's capital costs, the Commission's argument herein is obviously false. Memphis argues, contradictorily, that United's presence in the Corporate System lowers Union's capital costs. But the fact is that the Commission used Parent Corporation's cost of capital for *Union*, too, in Union's rate case. (31 F.P.C. at 74).

4. *United's Status As A Customer Of Union Does Not Justify Reductions Of United's Rates, Since United's Ratepayers Do Not Pay The Expenses Which Produce Union's Losses.*

The Commission "proves" too much when it next argues (Brief, p. 21) that, since United is a large customer of Union, the purchase of Union's gas by United means that Union's costs "are ultimately borne by United's ratepayers." If this argument were significant, it would mean that *every* large customer of a gas producer should have its rates set on the basis, at least partially, of the profits

or losses of its suppliers, so that United's rates would be affected by the fortunes of each of its suppliers. This, of course, is ridiculous, and is not, and could not be, done. In fact, however, the salient point is that in Union's rate cases, its jurisdictional rates are based only on its jurisdictional gas expenses—not its oil expenses—so that United pays none of the expenses which produce the oil losses. (31 F.P.C. at 48-49, 71-73).

The arguments of the Commission and Memphis are all directed to attempted creation of the illusion that United's ratepayers were participants in the ventures that were responsible for the losses sustained by United's fellow subsidiaries. The arguments, if logically extended, should also suggest that as a matter of equity, those ratepayers should be bearing the burden of the expenses which produced those losses of those non-jurisdictional affiliates. But the Commission does not suggest this—that United's ratepayers should support Union's oil exploration activities or Overseas' oil exploration efforts in Tunisia, for example.

The Commission and Memphis are correct when they say that the tax reductions involved herein arise because non-jurisdictional affiliates have losses. They err, however, in saying that United and its ratepayers somehow contribute to those losses, somehow share those losses with the stockholders of Parent Corporation, and somehow should benefit from them in the form of reduced rates. In fact, the losses incurred by United's non-jurisdictional affiliates in no way affect United's jurisdictional rates.

The Commission claims, however, that it is not unfair to seize the tax benefits from losses suffered by risk taking affiliates because the system stockholders (the Com-

mission claims) do not pay for *all* of the operations which produce those losses. The Commission (Brief, p. 23) says this is because United's ratepayers pay the expenses of United's operations, which include the cost of gas purchased from Union, which costs produced the losses of Union. This overlooks the fact that United points out in its brief that Union's gas operations, *which are the only ones which could even possibly "affect" United's gas costs,* since only gas costs are reflected in Union's jurisdictional gas rates, *do not produce a loss.*

5. *United Increased The Group Tax By 52% Of United's Income.*

Finally, the Commission and Memphis argue that United's tax allowance cannot be based upon the statutory 52% rate, because, they claim, no company in a system which files a consolidated return has a "separate tax liability." (Commission Brief, pp. 23, 24; Memphis Brief, pp. 23-27) This is irrelevant because neither presentation can refute the central fact of this case. *Because United is included in the consolidated tax return filed by the Corporate Group the actual total tax paid by the group is higher—by 52% of United's income—than it would have been if United were not included.* Thus, since United's jurisdictional operations "cost" the Corporate Group 52% of the income from those operations, it is not only equitable, but completely normal, that the jurisdictional ratepayers should pay that expense, just as they pay the other jurisdictional expenses. It is this concept which the Tenth Circuit expressed in *Cities Service* (adopted by the Fifth Circuit, below) when it said:

> The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52 percent rate, but its

tax liability at that rate was reported to the parent Company, and the consolidated returns actually reflect that tax liability.

Thus the consolidated return for 1957 shows a consolidated tax liability of $12,251,639 paid by Cities Service. If the Gas Company had filed a separate return, the consolidated tax liability would have amounted to $6,391,241, and the Gas Company's tax would have been $5,860,398 based upon the statutory 52 percent rate. The sum of these amounts precisely equals that which was actually paid by Cities Service. From this it is demonstrably clear that the inclusion of the Gas Company in the consolidated return increased the consolidated tax liability by 52 percent of the Gas Company's taxable income. No "tax savings" resulted from the inclusion of the Gas Company in the consolidated return.(*)

IV.

JUDICIAL, AND EVEN FEDERAL POWER COMMISSION, AUTHORITY OPPOSES THE COMMISSION'S "CONSOLIDATED EFFECTIVE TAX RATE" THEORY.

As noted, the only two federal courts which have considered a "consolidated effective tax rate" theory "allocating" losses of affiliates to reduce the rates of the jurisdictional company have reversed the Commission—in these *United* proceedings and in *Cities Service, supra.* Neither

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(*) 337 F.2d at 100. Footnote table omitted. Similarly, at the Commission level in *Cities Service,* two of the five Commissioners held that the pipeline's inclusion in the consolidated return increased the Corporate Group's tax by 52% of pipeline income so that the Parent Corporation had no tax advantage from such inclusion. 30 F.P.C. 158, 174 (1963).

the Commission nor Memphis have been able to cite contrary federal authority. Each, however, have alleged that the Commission has consistently utilized that theory. Even if accurate, that, of course, would not be controlling herein. The fact is, however, that prior to *Cities Service* and *United*, the only case in which the Commission considered whether it could reduce the rates of a jurisdictional company by use of losses suffered by the unregulated operations of an affiliated company—in that case the pipeline's parent—was *Olin Gas Transmission Corp.*, 17 F.P.C. 695 (1957). And in that case, the Commission refused to adopt a "consolidated effective tax rate" theory.

None of the other Commission cases(*) cited in the Commission's Brief herein, at page 14 (and Memphis' Brief, p. 15) involve losses of affiliates being used to decrease the pipeline's rates, and those cases are thus inapposite. In the interest of brevity, Natural and Texas Eastern here adopt Section III of the brief of *amicus*, Independent Natural Gas Association of America, herein, which discusses, and disposes of, those cases. That section of the *amicus* brief also demonstrates that the Court of Appeals position herein has been widely adopted in State regulatory proceedings.

(*) The only possible exception is *Home Gas Co.*, 13 F.P.C. 241 (1954), which does mention losses of affiliated, *jurisdictional* companies. It appears obvious that the Commission itself did not consider that case as precedent when subsequently it was faced with the question of benefits of tax losses of affiliated, but *non-jurisdictional* companies. See *Olin Gas Transmission Corp., supra.*

V.

THE COMMISSION'S "CONSOLIDATED EFFECTIVE TAX RATE" METHOD FRUSTRATES THE PURPOSE OF THE CONSOLIDATED RETURN PROVISIONS OF THE INTERNAL REVENUE CODE.

The Commission devotes pages 25-27 of its Brief to protests that its "consolidated effective tax rate" method is not inconsistent with the section of the Internal Revenue Code (26 U.S.C. § 1501) which allows the filing of a consolidated income tax return. But in so stating, the Commission's brief itself discloses that the contrary is true. The Commission admits (Brief, p. 26):

> Congress, in other words, desired to permit equal tax treatment between concerns that transact business through departments of a single corporation and those operating through subsidiary corporations.

That statement is quite true. And if the "United system" were a "single corporation", there would be no question but that United's tax allowance, to be included in its jurisdictional pipeline rates, would be computed by use of the statutory 52% tax rate.(*) There would be no "consolidated tax saving" for the Commission to attempt to use to reduce United's rates. But in this case, because a separate company corporate form is used, so that a

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(*) At page 19 of its brief, Memphis seems to disagree, citing *El Paso Natural Gas Co.* v. *FPC*, 281 F.2d 567 (5th Cir. 1960), where the Fifth Circuit upheld Commission use, in setting *El Paso's* rates, of tax deductions (for statutory depletion and intangible well-drilling costs) growing out of *El Paso's own natural gas production*. Since *El Paso* dealt with tax deductions from the *jurisdictional gas* operations of the jurisdictional company itself, and not with *non-jurisdictional* oil, overseas and intrastate gas operations, it is not in point in this case.

consolidated tax return is appropriate, the Commission is attempting to take away the current tax reduction, even though the Commission admits that the purpose of the Internal Revenue Code consolidated tax return provision is to treat multi-entity and single entity businesses equally.

The fact is that Congress passed the consolidated tax return section of the Internal Revenue Code so that multi-company corporate systems would be just as able to offset losses in some operations against gains in others, in the year of such losses, as are single-company corporate systems, *and in that way attempted to give the same encouragement to multi-entity systems to carry on risk-taking, investment producing enterprises, to stimulate the national economy.* The Commission's "consolidated effective tax rate" procedure frustrates that purpose by stripping the offset benefits away from multi-company systems if *any* member of the system is subject to Commission jurisdiction. This would mean that a non-jurisdictional company with a jurisdictional affiliate would be at a severe competitive disadvantage compared to a single company competitor, which further stifles incentive for risk-taking and puts multi-company entities at a severe disadvantage. Commissioner Woodward wrote, for himself and Commissioner O'Connor, in dissent against the three man majority in *Cities Service*:

> The Opinion and Order adopted by the majority is based on the false premise that, as to industries regulated by it, the Commission has the authority to limit the effect of a mandate of Congress as expressed in Section 1501 of the Internal Revenue Code. Depriving Gas Company of a tax allowance which would be routinely granted to it by the Commission if it were not for its having a common owner with an unregulated and unrelated petroleum business, should not be done without some very persuasive reasons based

upon sound rate-making policies which impose no confiscatory rates, which balance equitable consumer and investor interests and which take fully into consideration the impact of such action upon national economic policies. At the root of regulation is economic policy. The problem of economic growth in the United States is crucially important and inseparably related to economic growth is investment. Under the majority view, the consolidated return would not result in stimulating investment and growth because it has the effect of converting non-jurisdictional losses within the parent company's system into a rate reduction for gas consumers. The majority opinion is not supported by persuasive reasons based on sound policy.(*)

CONCLUSION.

The only two Courts of Appeals which have considered the question involved in these proceedings have held the Commission to be in error. One such holding was the decision of the Court of Appeals, below. It should be affirmed.

Respectfully submitted,

JACK D. HEAD
JOSEPH F. WEILER
Texas Eastern Transmission Corporation
P. O. Box 2521
Houston, Texas 77001

KEITH M. PYBURN
Texas Eastern Transmission Corporation
Suite 852
Pennsylvania Building
Washington, D. C. 20004

Attorneys for Respondent,
Texas Eastern Transmission Corporation

CHARLES C. McDUGALD
WILLIAM W. BRACKETT
DONALD W. GLAVES
STEVEN L. LARSON
ROSS, HARDIES, O'KEEFE, BABCOCK, McDUGALD & PARSONS
122 South Michigan Avenue
Chicago, Illinois 60603

Attorneys for Respondent,
Natural Gas Pipeline Company of America

(*) 30 F.P.C. at 172.

SUPREME COURT OF THE UNITED STATES

Nos. 127 AND 128.—OCTOBER TERM, 1966.

Federal Power Commission, Petitioner, 127 v. United Gas Pipe Line Company et al.	On Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit.
Memphis Light, Gas and Water Division, Petitioner, 128 v. United Gas Pipe Line Company et al.	

[March 13, 1967.]

MR. JUSTICE WHITE delivered the opinion of the Court.

The question here is whether the Federal Power Commission, in the course of determining just and reasonable rates for United Gas Pipe Line Company (United) under § 4 (e) of the Natural Gas Act, 52 Stat. 822, 15 U. S. C. § 717c (e), made a proper allowance for federal income taxes in calculating the company's cost of service. United claimed that in determining the cost of service its allowance for federal income taxes should be at the full 52% rate, or $12,099,662, for the test year. The Commission disagreed because United was a member of an affiliated group which during the five-year period of 1957–1961 had elected to file consolidated returns for federal income tax purposes,[1] a fact which in the Commission's

[1] The election was pursuant to the privilege granted in § 1501 of the Internal Revenue Code of 1954, 26 U. S. C. § 1501. The other members of the affiliated group are United Gas Corporation, which wholly owns United and which is a gas distribution company subject to state and local regulation, and two other wholly owned

view required a reduced tax allowance in the company's cost of service. Had consolidated returns not been filed during the five-year period and had each company in the affiliated group instead filed separate returns, the total tax for the group would have been several million dollars more than was paid on a consolidated basis. This was so because on a consolidated basis consolidated losses serve to reduce consolidated income and because two members of the group, Union and Overseas, had net losses over the five-year period, thereby reducing taxes by an average of over $1,000,000 per year.

To determine what the Commission considered the proper tax allowance for United's rate base, it allocated the actual consolidated taxes paid during the five-year period among the members of the group in accordance with a formula it had developed in *Cities Service Gas Co.*, 30 F. P. C. 158, the order in which was set aside after issuance of the order in the instant case, 337 F. 2d 97. As so allocated, United's annual share of the consolidated tax was 50.04% of its taxable income. Using this rate, the Commission allowed United $9,940,892 for federal income taxes instead of the $12,099,662 claimed by United. 31 F. P. C. 1180, 1191.

The Court of Appeals, relying on the decision of the Circuit Court of Appeals for the Tenth Circuit in *Cities Service Gas Co.* v. *FPC*, 337 F. 2d 97, held "the tax allocation as made by the Commission's order was contrary to the requirements which Congress had imposed," 357 F. 2d 230, 231, and hence vacated and set aside the order. We reverse and remand to the Court of Appeals for further proceedings.

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subsidiaries of United Gas Corporation—Union Producing Company (Union), a domestic oil and gas producer whose interstate sales of gas are subject to the jurisdiction of the Federal Power Commission, and United Overseas Production Company (Overseas) which is engaged in oil exploration in foreign countries.

I.

In the *Cities Service* case the affiliated group filing the consolidated return was composed of both regulated and unregulated companies. Some of the unregulated companies had taxable income, others had even larger losses, and, therefore, as a group the unregulated companies showed a net loss over the representative years used by the Commission to forecast the future federal income tax element of cost of service. The regulated companies as a group, on the other hand, had taxable income in the same period. On an unconsolidated basis the individual members of the affiliated group would have paid a considerably larger total tax than was actually paid on the consolidated basis. The Gas Company whose tax allowance for rate purposes was being determined claimed that it was entitled to the full 52% of its own taxable income. Its position was that the Commission had no power at all to apply any of the losses of unregulated companies to reduce its tax allowance and hence its rates. The tax allowance was thus to be figured at 52% without regard to the taxes actually paid by the affiliated group on a consolidated basis, seemingly even if the group paid no tax at all.

For the Commission, however, the only real cost to the regulated company was related to the consolidated tax actually paid and incurred in connection with the other companies in the group. In the Commission's view, it was unacceptable to determine the cost of service on a hypothetical figure—to fix jurisdictional rates "on the basis of converting a hypothetical tax payment into a prudent operating expense." 30 F. P. C. 158, 162. It refused to accept the argument that "Gas Company ratepayers should make Cities Service stockholders whole for the tax losses of nonregulated enterprises even though this means an allowance for taxes over and beyond that

which the consolidated system as a whole actually paid." *Ibid.* The Commission's function, it said, was to fix just and reasonable rates, not to insure that other affiliates would be made whole for their tax losses out of income from regulated enterprises. Thus the task was "to determine the proportion of the consolidated tax which is reasonably attributable to the gas company *vis-à-vis* the other Cities Service affiliates." 30 F. P. C. 158, 162.

To make this determination, the Commission devised a formula which in effect applied the losses of unregulated companies first to the gains of other unregulated companies.[2] If a net taxable income remained in the unregulated group, the regulated companies would not

[2] "[T]he proper method to be applied in computing the Federal income taxes to be included in the cost of service of a regulated company where that company has joined in a consolidated tax return with affiliates is (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate making purposes, if computed on a separate return basis." 30 F. P. C. 158, 164.

As the Commission noted, 30 F. P. C. 158, 162, it could draw little from the experience of state and local regulatory bodies dealing with the question whether the losses of affiliates should be taken into account in determining the tax allowance for regulated enterprises since the state and local solutions had not been consistent. It does not appear that the Commission drew on its own experience, although with a single exception the Commission seems to have accounted for consolidated tax savings in past ratemaking proceedings. See *Penn-York Natural Gas Co.*, 5 F. P. C. 33, 39 (1946); *Hope Natural Gas Co.*, 10 F. P. C. 583, 612, aff'd, 10 F. P. C. 625 (1951); *Atlantic Seaboard Corp.*, 11 F. P. C. 486, 515, aff'd, 11 F. P. C. 43, remanded on other grounds, 200 F. 2d 108 (1952); *United Fuel Gas Co.*, 12 F. P. C. 251 (1953); *Hope Natural Gas Co.*,

share in the savings from the consolidated return and would be deemed to have paid a tax at the full 52% rate. But if losses of the unregulated companies exceeded their net income and hence reduced the taxes of the regulated group below what they would have paid had they filed separate returns, the consolidated tax paid would be allocated among the regulated companies in proportion to their taxable incomes. As applied to the facts in the *Cities Service* case, the formula resulted in a tax allowance of $5,866,847 rather than the $7,055,981 claimed by the Cities Service Gas Company.

The Court of Appeals set aside the Commission's order. In its view, the addition of the gas company's income to the consolidated return cost the affiliated group exactly 52% of the taxable income of the gas company, either in taxes paid or in a reduction of loss carry-forwards or carry-backs. The Commission's formula as applied was therefore held to appropriate losses of unregulated companies and to exceed the Commission's "jurisdictional limits which require an effective separation of regulated and nonregulated activities for the determination of the ingredients of the rate base . . . mean[ing] a separation of profits and losses between regulated and nonregulated businesses in determining the tax allowance in the cost of service of the regulated company." 337 F. 2d 97, 101. Hence the court, relying on *Colorado Interstate Gas Co.* v. *FPC*, 324 U. S. 581, and *Panhandle Eastern Pipe Line Co.* v. *FPC*, 324 U. S. 635, set aside the Commission's order.

II.

In our view what the Commission did here did not exceed the powers granted to it by Congress. One of its

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12 F. P. C. 342, 347 (1953); *Home Gas Co.*, 13 F. P. C. 241, 246 (1954); *United Fuel Gas Co.*, 23 F. P. C. 127, 134 (1960). But see *Olin Gas Transmission Corp.*, 17 F. P. C. 685 (1956).

statutory duties is to determine just and reasonable rates which will be sufficient to permit the company to recover its costs of service and a reasonable return on its investment. Cost of service is therefore a major focus of inquiry. Normally included as a cost of service is a proper allowance for taxes, including federal income taxes. The determination of this allowance, as a general proposition, is obviously within the jurisdiction of the Commission. Ratemaking is, of course, subject to the rule that the income and expense of unregulated and regulated activities should be segregated. But there is no suggestion in this case that in arriving at the net taxable income of United the Commission violated this rule. Nor did it in our view in determining the tax allowance. United had not filed its own separate tax return. Instead it had joined with others in the filing of a consolidated return which resulted in the affiliated group paying a lower total tax than would have been due had the affiliates filed on a separate return basis. The question for the Commission was what portion of the single consolidated tax liability belonged to United. Other members of the group should not be required to pay any part of United's tax, but neither should United pay the tax of others. A proper allocation had to be made by the Commission. Repondents insist that in making the allocation the Commission would violate the statute unless in every conceivable circumstance, including this one, United is allowed an amount for taxes equal to what it would have paid had it filed a separate return. In their view United should never share in the tax savings inherent in a consolidated return, even if on a consolidated basis system losses exceed system gains and neither the affiliated group nor any member in it has any tax liability. This is an untenable position and we reject it. Rates fixed on this basis would give the pipe line company and its stockholders not only the fair return to which they are entitled

but also the full amount of an expense never in fact incurred. In such circumstances, the Commission could properly disallow the hypothetical tax expense and hold that rates based on such an unreal cost of service would not be just and reasonable.

It is true that the avoidance of tax and the reduction of the tax allowance is accomplished only by applying losses of unregulated companies to the income of the regulated entity. But the Commission is not responsible for the use of consolidated returns. It is the tax law which permits an election by an appropriate group to file on a consolidated basis. The members of a group, as in this case, themselves choose not to file separate returns and hence, for tax purposes, to mingle profits and losses of both regulated and unregulated concerns, apparently deeming it more desirable to attempt to turn the losses of some companies into immediate cash through tax savings rather than to count on the loss companies themselves having future profits against which prior losses could be applied. Such a private decision made by the affiliates, including the regulated member, has the practical and intended consequence of reducing the group's federal income taxes, perhaps to zero, as was true of one of the years involved in the *Cities Service* case. But when the out-of-pocket tax cost of the regulated affiliate is reduced, there is an immediate confrontation with the ratemaking principle that limits cost of service to expenses actually incurred. Nothing in *Colorado Interstate* or *Panhandle* forbids the Commission to recognize the actual tax saving impact of a private election to file consolidated returns. On the contrary, both cases support the power and the duty of the Commission to limit cost of service to real expenses.[2]

[2] See *Colorado Interstate Gas Co.* v. *FPC*, 324 U. S. 581, 604–605; *Panhandle Eastern Pipe Line Co.* v. *FPC*, 324 U. S. 635, 648–649; *El Paso Natural Gas Co.* v. *FPC*, 281 F. 2d 567, 573, cert. denied

We think that in the proper circumstances the Commission has the power to reduce cost of service, and hence rates, based on the application of nonjurisdictional losses to jurisdictional income. Hence, the question becomes one of when and to what extent the tax savings flowing from the filing of a consolidated return are to be shared by the regulated company. Or, to put it in the Commission's words the issue is one of determining "the proportion of the consolidated tax which is reasonably attributable to the gas company *vis-à-vis* [its] other . . . affiliates." 30 F. P. C. 158, 162.

Viewing the case in this light, we cannot say that the method the Commission chose to allocate the tax liability among the group members was erroneous or contrary to its statutory authority. Under its formula, the net losses and net income of unregulated companies are first set off one against the other, and the tax savings made possible by losses of unregulated enterprises are thus first allocated to the unregulated companies. Only if "unregulated" losses exceed "unregulated" income is the regulated company deemed to have enjoyed a reduction in its taxes as a result of the consolidated return. If there is more than one regulated company in the group, they will share the tax liability or tax saving in proportion to their taxable income.

It is true that the Commission includes in the regulated group companies which are regulated not by it but by state or local authorities and that under the Commission's formula enterprises not subject to its jurisdiction may be required to share the tax saving with the federally regulated concern. But we know of nothing in the law or the statutes governing the ratemaking activi-

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sub nom. California v. *FPC*, 366 U. S. 912; *Alabama-Tennessee Natural Gas Co.* v. *FPC*, 359 F. 2d 318, 331, cert. denied, 385 U. S. 847.

ties of the Commission which dictates priority for the state regulated company or which provides that the jurisdictional company may share in the tax saving only if the saving exceeds the separate return tax liability of the state regulated company. One could as well argue that for ratemaking purposes the company subject to federal regulation should have the first benefit of the tax saving. The Commission's formula, of course, prefers neither concern but allocates the tax liability equitably between each regulated member, without regard to the source of the regulation.[4] "When the Congress, as here, fails to provide a formula for the Commission to follow, courts are not warranted in rejecting the one which the Commission employs unless it plainly contravenes the statutory scheme of regulation." *Colorado Interstate Gas Co.* v. *FPC*, 324 U. S. 581, 589. "If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." *FPC* v. *Hope Natural Gas Co.*, 320 U. S. 591, 602.

There is no frustration of the tax laws inherent in the Commission's action. The affiliated group may continue to file consolidated returns and through this mechanism set off system losses against system income, including the United's fair return income. The tax law permits this, but it does not seek to control the amount of income which any affiliate will have. Nor does it attempt to set United's rates. This is the function of the Commission, a function performed here by rejecting that part of

[4] That some sharing of the tax savings with nonfederally regulated companies was in order seems to have been recognized by the members of the affiliated group. Under the internal allocation formula employed by the group, the tax liability assigned to United represented an effective tax rate of 48.8%.

the claimed tax expense which was no expense at all, by reducing cost of service and therefore rates, and by allowing United only a fair return on its investment.

Nor did the Commission "appropriate" or extinguish the losses of any member of the affiliated group, regulated or unregulated. Those losses may still be applied to system gains and thereby turned into instant cash. United may, of course, have less income than it [illegible]. If so, this will correspondingly reduce the opportunity of the affiliated group to use the losses of unregulated companies to appropriate United's income for the benefit of nonjurisdictional activities because United's income will no longer offset the same amount of losses which it once did. But the losses of unregulated companies are in no way destroyed. They remain with the system, readily available to reduce the taxes of the profitable affiliates to the maximum extent allowed by the tax law.

Another matter deserves some comment. It is said here that the Commission, in applying its tax allowance formula, erroneously failed to recognize and to take account of the fact that United has both jurisdictional and nonjurisdictional activities and income. Although this is a matter which might affect the results achieved in application of the Commission's formula, it is one to which the Court of Appeals has not addressed itself, and we think it appropriate for the issue to be raised there if the parties are so inclined.

For the reasons stated herein, the judgment of the Court of Appeals is reversed and the cases remanded for further proceedings consistent with this opinion.

It is so ordered.

MR. JUSTICE FORTAS took no part in the consideration or decision of these cases.

SUPREME COURT OF THE UNITED STATES

Nos. 127 AND 128.—OCTOBER TERM, 1966.

Federal Power Commission, Petitioner, 127 v. United Gas Pipe Line Company et al.	On Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit.
Memphis Light, Gas and Water Division, Petitioner, 128 v. United Gas Pipe Line Company et al.	

[March 13, 1967.]

MR. JUSTICE HARLAN, whom MR. JUSTICE DOUGLAS and MR. JUSTICE STEWART join, dissenting.

My analysis of the elusive issue involved in this case leads me to different conclusions from those reached by the Court and to agreement with the result reached by the Court of Appeals on the facts of this case.

We are presented here with the problems of resolving an apparent conflict between the consolidated tax return provisions of the Internal Revenue Code,[1] which permit an affiliated group of corporations, in this instance having some activities within and some without the Federal Power Commission's jurisdiction, to be treated as a "business entity" for tax purposes,[2] and the Natural Gas Act which imposes on the Commission the duty of observing "the fundamental ratemaking principle [that] . . . requires a separation between regulated and unregulated costs

[1] 26 U. S. C. §§ 1501–1505.

[2] "The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise." S. Rep. No. 960, 70th Cong., 1st Sess., p. 14.

and revenues." *Cities Service Gas Co.*, 30 F. P. C. 158, 162. The Court holds that the FPC may resolve the apparent dilemna by working only with "the single consolidated tax liability" and determining by allocation what portion should be attributed to United for ratemaking purposes. By filing a consolidated return the members of the affiliated group are said "to merge profits and losses of both regulated and unregulated concerns" and thus create the necessity for allocation. The only serious problem the Court sees is the resolution of the question "when and to what extent the tax savings flowing from the filing of a consolidated return are to be shared by the regulated company." And the Court attempts to sidestep sharp analysis of that problem by resorting to the principle that, in ratemaking, the end in effect justifies the means.[3]

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[3] The Court's opinion seizes on the language of *FPC* v. *Hope Natural Gas Co.*, 320 U. S. 591, 602, for the proposition that judicial inquiry must be at an end when it is determined that a rate order "cannot be said to be unjust and unreasonable." But the problem before the Court in that case was an entirely different one. There it was argued that the Court was obligated to delve into the details of an initial ratemaking in order to determine whether certain rates were reasonable. The Court held that in an initial ratemaking the essential question was only whether the return actually allowed permitted the company to sustain itself in the market. The Court noted that it could not become involved in questions of "fair value" because "the value of the going enterprise depends on earnings under whatever rates may be anticipated." *Id.*, at 601. Nothing in *Hope Natural Gas* suggests that courts are powerless to review a particular formula to determine whether it is based on rational criteria. A return which is "just and reasonable" must reflect underlying congressional policies. Thus courts have not hesitated to review the underlying rationales of Commission decisions while giving due deference to the Commission's discretion. See, *e. g.*, *Tennessee Gas Transmission Co.* v. *FPC*, 293 F. 2d 761; *United Gas Imp. Co.* v. *FPC*, 290 F. 2d 133; *Detroit* v. *FPC*, 230 F. 2d 810.

As will be developed more fully below, I think that the Court's resolution of the jurisdictional issue, while possessing a certain surface plausibility, mistakes the operation of the tax laws and permits the Commission to place regulatory pressure on entities and business decisions wholly outside its jurisdiction under the Natural Gas Act. I think also that the Commission's formula cannot be upheld even under the Court's jurisdictional analysis. The formula indefensibly undercuts the policy of the tax laws, and thus cannot be considered a means of reaching "just and reasonable" rates. Cf. *El Paso Natural Gas Co.* v. *FPC*, 281 F. 2d 567.

I.

The Court's "single consolidated tax liability" approach ignores the fact that what is consolidated is corporate taxable incomes rather than the underlying revenues and deductions. Thus what has happened in this case is not the imposition of a single tax liability on the activities, as a whole, of the affiliated corporate group, but the reduction of the sum of separate 52% corporate tax liabilities by the setoff of tax losses against taxable income. Certainly there can be no contention that United would be entitled to anything other than a 52% of taxable income tax expense for ratemaking purposes absent tax losses in the consolidated group.[4] The only question that properly arises on this record is whether the Commission

[4] Thus despite the Court's "single consolidated tax liability" phraseology, I am certain that the Court does not mean to imply that the Commission may allocate by any criterion other than taxable incomes. The Court cannot mean to suggest that, for example, the Commission is empowered to allocate by gross revenues and thus consider special deductions belonging to nonjurisdictional activities as allocable for ratemaking purposes when the nonjurisdictional activity is fully capable of using them.

could consider any setoff to have been made against United's tax liability for ratemaking purposes when nonjurisdictional activities could have taken full advantage of the setoffs belonging to the group and the group desired to allocate them to those activities.[5]

The "tax losses" belonging to the group arose almost exclusively from the excess of depletion allowances over revenues in the returns of the nonjurisdictional activities,

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[5] In determining what it considered to be the properly allocated percentage of "tax saving" for ratemaking purposes the Commission utilized a five-year average (1957–1961) to eliminate the effects of short-term fluctuation. During that period, the total tax losses of Union and Overseas were $3,893,980. The total taxable income of Gas Corporation, all of which was nonjurisdictional, was $9,024,170. Moreover, 56% of United's taxable income of $105,290,983 was nonjurisdictional. Thus even in the two years, 1960 and 1961, when the tax losses of Union and Overseas exceeded the taxable income of Gas Corporation, the group's nonjurisdictional taxable income was more than sufficient to offset all tax losses.

The Court notes the observation, made by the FPC in its brief, p. 26, that United reflected a "tax saving" on its books. This statement is somewhat misleading since it is directed to the allocation made for earnings and profits tax purposes under 26 U. S. C. § 1552 (a)(1) and that allocation bears no necessary relation to the actual allocation of liability for corporate purposes. Exhibit 14–1 reveals that, on the basis of allocated liability for corporate purposes, United had an average effective tax rate of 51.749% for the test years.

Moreover, the allocation of setoffs in the 1957–1961 period has no direct relevance to the issue in this case for the Commission was not engaged in analyzing rates for that period. The rates under scrutiny were those United proposed to charge in the future. If the Commission had found that United actually intended to allocate setoffs to its jurisdictional operation for corporate purposes while attempting to take a full 52% tax expense deduction for ratemaking purposes, the Commission might well have been justified in recognizing the setoffs for ratemaking purposes to the extent that United actually utilized them. On this record, it is clear that the Commission did not make any such finding.

Union and Overseas. Such allowances belonged to Union and Overseas and those corporations were entitled to their exclusive use. By agreeing to the consolidated return [6] Union and Overseas agreed to deliver to the group, in any taxable year, whatever deductions they themselves could not then utilize in their own returns. The question how to allocate the benefit of those deductions among the members of the group would seem to be one for the group rather than the Commission when, as here, they do not arise from jurisdictional activities and can be used by group members other than the jurisdictional activity. The courts have allowed good-faith business decisions to control such allocations for the vital purpose of determining which corporations shall pay the tax. See *Case* v. *New York Central R. R. Co.*, 15 N. Y. 2d 150, 204 N. E. 2d 643. And the Tax Commissioner would permit the group to allocate for earnings and profits purposes in precisely the manner the group has chosen here.[7] Although these decisions cannot control for ratemaking purposes, they do make it clear that the Commission's assertion of jurisdiction to allocate amounts to an order that certain nonjurisdictional assets be delivered up to jurisdictional use since there is no other compulsion for such an allocation. The Court asserts that "[o]ne could as well argue for ratemaking purposes that the company subject to federal regulation should have the first benefit of the tax saving." But no authority or reason is given in support of this assertion, and, in my opinion, none can be found. The Commission has no

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[6] 26 U. S. C. § 1501 requires that all of the affiliated corporations consent to the filing of the consolidated return.

[7] Proposed Treas. Reg. § 1.1502-33 recently promulgated by the Commissioner of Internal Revenue makes this a permissible means of allocation. 31 Fed. Reg. 16788-16789.

authority to control the disposition of nonjurisdictional assets or the revenues or losses arising therefrom.

A parallel example will make even clearer the jurisdictional violation arising from the Commission's action here. If Union or Overseas had found itself with an excess quantity of steel pipe useful to all members of the group and had to negotiate its sale at a discount, one could hardly "as well argue for ratemaking purposes" that United should be credited with the discount purchase when the pipe had been sold to Gas Corporation and United had been forced to purchase pipe at the market.[8] And it could not be asserted that the Commission would have authority to order the transfer of the discount pipe to United.[9]

The far-reaching nonjurisdictional impact of the Commission's ruling gives further evidence that its action was one which Congress could not have contemplated and would not have condoned. As the dissenting Commissioners pointed out in the *Cities Service Gas Co.* pro-

[8] And this nonjurisdictional decision would seem outside the Commission's control even if it were influenced by the fact that United could benefit less from the lower price because the ratepayers would absorb the benefit. Union and Overseas have no duty to act for the benefit of United's ratepayers. And if United were to join in a group compact agreeing to this allocation of excess pipe with the proviso that the excess would be sold to United in the absence of other needs, the decision would seem perfectly justifiable. United's contingent benefit would be more than it would have outside the compact, and since United has no right to compel the nonjurisdictional corporations to deal with it, United would not have surrendered anything. See *Case* v. *New York Central R. R. Co.*, 15 N. Y. 2d 150, 204 N. E. 2d 643.

[9] It should be noted as well that this example makes clear that it is entirely normal for United to be expected to pay for the acquisition of the asset, and thus some consideration should pass to Union and Overseas. This point is further developed in Part II of this opinion.

ceeding, *supra*, at 175, the Commission has made jurisdictional rates turn on the corporate form assumed by nonjurisdictional activities. If, for example, the group had separately incorporated its nonjurisdictional operations, they would have shown taxable income in filing the consolidated return and no ratemaking allocation would be forthcoming. Similarly, since the Commission regulations themselves require separation of jurisdictional and nonjurisdictional operations within a single corporation, all the affiliates could merge into United and since nonjurisdictional activities would show a net taxable income, United would receive a 52% tax expense for ratemaking purposes.[10] The congressional purpose in allowing consolidated returns was to eliminate exactly this kind of dependence on corporate form and leave corporations free to continue business in whatever corporate form best suited them. See, *e. g.*, S. Rep. No. 960, 70th Cong., 1st Sess., 14. The congressional purpose in passing the Natural Gas Act was to prevent exploitation of the natural gas consumer. It was not to prevent natural gas companies from fully developing their nonjurisdictional opportunities, nor to control in any way the form of those activities, nor to appropriate nonjurisdictional assets for the benefit of consumers. *Colorado Interstate Gas Co.* v. *FPC*, 324 U. S. 581, 593–594.

The Court focuses its analysis on a case, not presented here, in which there are *net* nonjurisdictional losses and the consolidated tax liability is thus less than 52% of the taxable income of the jurisdictional activity. In such a case it is clear that nonjurisdictional assets are being used for tax purposes by the jurisdictional activity and it would blink reality not to recognize this use for

[10] Title 18 CFR § 154.63 (f) which deals with joint facilities requires allocation of expenses between jurisdictional and nonjurisdictional activities.

ratemaking purposes, just as it would be wholly improper not to recognize the lower cost of discount pipe when a jurisdictional activity actually purchased it from a nonjurisdictional affiliate. When the group's election to file consolidated returns, or its intercorporate arrangements, *require* that nonjurisdictional deductions be utilized to set off jurisdictional income then, and only then, can there, in my opinion, be allocation.[11] That, however, is not the situation here where nonjurisdictional income was fully capable of absorbing all nonjurisdictional losses.

II.

In a well-reasoned opinion in *El Paso Natural Gas Co.* v. *FPC*, 281 F. 2d 567, the court held that the Commission properly took account of depletion allowances arising from jurisdictional activities in fixing rates. The gas company there had argued that since Congress intended by the allowance to encourage exploration its benefit could not be passed on to the ratepayers. The court rejected that argument because it concluded that the proper place to reflect the congressional policy was in the ultimate rate of return allowed the company. It made explicit, however, that the Commission could not fail to take account of the congressional policy.

The Court's opinion departs from that sound analysis by sustaining a formula which allocates the entire "tax saving" to the "regulated" corporations and thus fails to take account of the congressional desire to benefit the loss

[11] This formulation is, of course, very similar in form to that utilized by the Commission. The essential difference lies in the fact that the Commission substituted the concept of a "regulated corporation" for that of a jurisdictional activity. The regulated-unregulated division made by the Commission has no basis in the Natural Gas Act.

corporations by allowing the profit corporations to retain earnings which could be passed on to them. The consolidated return is the horizontal equivalent of the vertical loss carry forward and carryback provisions of the Internal Revenue Code. It allows the "business unit" to recoup from the Government some of the loss which has been sustained and, in the words of Mr. Justice Jackson, "it is probable that the intention . . . was to provide salvage for the loser . . . ." *The Western Pacific R. R. Case*, 345 U. S. 247, 277 (dissenting opinion). Any rate formula which does not provide a means of allocating benefit to the loss corporation cannot then be "just and reasonable." And if the group as a whole does not benefit from consolidation because the setoff advantages of losses are absorbed by the "regulated" corporations and passed on to the ratepayers, it is most unlikely that the loss corporations will achieve the benefit Congress intended them to have.[12]

The Court recognizes the adverse effect on the benefits flowing to the loss corporations, but contends there is no frustration of the tax laws because the losses "remain with the system, readily available to reduce the taxes of the profitable affiliates . . . ." But this hypothetical "availability" is meaningless for the "instant cash" produced by the losses is passed on to the ratepayers rather than, as the tax laws intend, to the loss corporations. The fact that the group's tax payment is lower will not

[12] The Commission has argued that the intended benefit can be disregarded in this case because the loss corporations are in that category for tax purposes solely because of depletion allowances and are actually profitable in economic terms. While this argument might be thought to have some force, it is not for us to decide that the depletion allowances Congress has authorized are not real costs of carrying on the business.

satisfy the intent behind the revenue provisions which was not to reduce government collections but to increase resources available to the business unit.[13]

III.

To summarize, I think, first, that no allocation whatever could be required by the Commission in this case because nonjurisdictional income was more than sufficient to absorb all nonjurisdictional losses and there was no showing that jurisdictional activities would actually benefit from nonjurisdictional losses. To permit the FPC in such circumstances to allocate would in effect extend the Commission's jurisdiction to areas not encompassed within the authority given the Commission by the Natural Gas Act. While the basic purpose of the Act is, of course, to protect ratepayers, Congress has not carried that protection so far as to allow them to share in the benefits of the nonjurisdictional activities of a jurisdictional corporation or those of its corporate affiliates—a result which today's decision permits the Commission to achieve.

Second, in instances where the Commission may allocate, it seems to me that any allocation formula that does not take account of the underlying policy of the tax statute would "plainly [contravene] the statutory scheme of regulation." *Colorado Interstate Gas Co.* v. *FPC*, *supra*, at 589.

Third, while I thus agree with the Court of Appeals that United, on this record, is entitled to have its rates

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[13] The Commission, if not the Court, was aware of this problem. In its petition for certiorari, p. 10, n. 8, the Commission recognized that "[t]here may indeed be problems in the application of . . . a formula which may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group." The Commission has not attempted to justify its formula to this Court.

calculated on the premise of a full 52% tax liability, I cannot subscribe to such intimations as there may be in the opinion relied upon by that court that the Commission may *never* allocate in a consolidated tax situation.

I would affirm the judgment of the Court of Appeals.[14]

[14] Since, in my view, no allocation is permissible in the circumstances of this case, as a matter of law, a remand to the FPC is unnecessary. Under the Court's view, however, such a remand would appear to be the appropriate disposition. The Court's "single consolidated tax liability" jurisdictional formulation is essentially the "fused mass" theory proposed by the Commission staff and rejected by the Commission for jurisdictional reasons. *Cities Service Gas Co.*, 30 F. P. C. 158, 160. The Commission should at least be required to re-examine the matter under the Court's jurisdictional premises. *SEC* v. *Chenery Corp.*, 318 U. S. 80; *Connecticut Light & Power Co.* v. *FPC*, 324 U. S. 515, 534. In any event, I cannot understand the Court's remand to the Court of Appeals, the Commission's power to allocate and its allocation formula having already been upheld by this Court.